

# QUARTERLY ECONOMIC COMMENTARY

Autumn 2010

ALAN BARRETT  
IDE KEARNEY  
THOMAS CONEFREY  
CORMAC O'SULLIVAN



THE ECONOMIC AND SOCIAL RESEARCH INSTITUTE



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*The forecasts in this Commentary are based  
on data available by mid-October 2010*

## RESEARCH BULLETIN

10/3

Editor: Tim Callan

Available to download from [www.esri.ie](http://www.esri.ie)

The Economic and Social Research Institute (Limited Company No 18269)  
Registered office: Whitaker Square, Sir John Rogerson's Quay, Dublin 2

*Price €90 per copy or €350 per year,  
(including Medium-Term Review, 2008-2015)*

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The *Commentary* and *Research Bulletin* contained within have been accepted for publication by the Institute, which is not responsible for either the content or the views expressed. Draft completed 19th October 2010.

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Alan Barrett, Ide Kearney, Thomas Conefrey and Cormac O’Sullivan

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# SUMMARY TABLE

	2008	2009	2010	2011
<b>OUTPUT</b>				
(Real Annual Growth %)				
Private Consumer Expenditure	-1.5	-7.0	- ½	1
Public Net Current Expenditure	2.2	-4.4	-3	-3
Investment	-13.7	-31.0	-25 ½	-3 ¼
Exports	-0.8	-4.1	7 ½	5 ½
Imports	-2.9	-9.7	3 ½	3 ¾
Gross Domestic Product (GDP)	-3.4	-7.6	- ¼	2 ¼
Gross National Product (GNP)	-3.5	-10.7	-1 ½	2
GNP per capita (constant prices)	-5.3	-11.4	-1 ¾	2 ¼
<b>PRICES</b>				
(Annual Growth %)				
Harmonised Index of Consumer Prices (HICP)	3.3	-1.7	-1 ½	½
Consumer Price Index (CPI)	4.1	-4.5	- ¾	1 ¾
Wage Growth	2.9	-0.8	-3	-1
<b>LABOUR MARKET</b>				
Employment Levels (ILO basis (000s))	2,100	1,928.5	1,860.1	1,849.9
Unemployment Levels (ILO basis (000s))	141	258.6	286.1	289.0
Unemployment Rate (as % of Labour Force)	6.3	11.8	13 ¼	13 ½
<b>PUBLIC FINANCE</b>				
Exchequer Balance (€bn)	-12.7	-24.6	-18.1	-21.1
General Government Balance (€bn)	-13.2	-23.4	-48.9	-16.1
General Government Balance (% of GDP)	-7.3	-14.6	-31	-10
Excluding Bank Payments		-12.1	-11 ½	
General Government Debt (% of GDP)	44.4	65.6	97 ¼	105
<b>EXTERNAL TRADE</b>				
Balance of Payments Current Account (€bn)	-10	-4.9	-0.1	1.6
Current Account (% of GNP)	-6.6	-3.7	0	1 ¼
<b>EXCHANGE AND INTEREST RATES</b> (averages)				
US\$/€ Exchange Rate	1.47	1.39	1.31	1.28
STG£/€ Exchange Rate	0.79	0.89	0.85	0.83
Main ECB Interest Rate	2.50	1.00	1.00	1.25



# SUMMARY

The two most significant announcements on economic matters since the last *Commentary* were the release of the *Quarterly National Accounts* for Q2 2010 on 23 September 2010 and the government's statement on banking on 30 September. In the case of the former, the news was, at best, disappointing while in the case of the latter, it was horrendous. Both have impacted upon our view of the timing of potential recovery in the economy and on appropriate policy.

We now expect that GNP will contract by  $1\frac{1}{2}$  per cent this year, down from  $-\frac{1}{2}$  per cent in our *Summer Commentary*. For GDP, we now expect there to be a decline of  $\frac{1}{4}$  per cent this year. This represents a change on our summer forecast when we expected GDP to grow by  $\frac{1}{4}$  per cent. For 2011, we expect GNP to grow by 2 per cent and for GDP to grow by  $2\frac{1}{4}$  per cent. Again, these are marginally down relative to our last *Commentary*.

We now expect that employment will average 1.86 million this year, down 68,000 from 2009, a fall of  $3\frac{1}{2}$  per cent. We expect the rate of unemployment to average  $13\frac{1}{4}$  per cent. For 2011, we expect the number employed to average 1.85 million and the rate of unemployment to average  $13\frac{1}{2}$  per cent.

In the year ending April 2010, the Central Statistics Office (CSO) recorded net outward migration to have been 34,500. This was well below our forecast of 70,000. However, we discuss how this figure of 34,500 seems to be a conservative estimate of the rate of outflow when compared with estimates of migration contained in another CSO publication, namely, the *Quarterly National Household Survey*. We expect the net outflow in the year ending April 2011 to be 60,000. This is an increase of 10,000 on our earlier forecast.

The General Government Deficit is expected to be 31 per cent of GDP this year, a truly dramatic figure. Of course, almost two-thirds of this is a one-off extraordinary item related to the banking bailout. For 2011, we expect the deficit to be 10 per cent of GDP, based on a budgetary package of €4 billion in savings.

On inflation, we expect HICP inflation to average  $-1\frac{1}{2}$  per cent this year and  $+\frac{1}{2}$  per cent in 2011. For the CPI, the corresponding forecasts are  $-\frac{3}{4}$  per cent in 2010 and  $+1\frac{3}{4}$  per cent in 2011. We expect wage growth to be negative in both 2010 and in 2011, at rates of -3 per cent and -1 per cent respectively.

In our *General Assessment*, we look at the budgetary challenges facing the country and in particular at the prospects of bringing the deficit down to sustainable levels in a reasonable time frame. Using the low growth profile as published by the ESRI in July 2010, we assess what level of savings will be required to achieve a deficit of 3 per cent by 2014. Our calculations suggest that savings of up to €15 billion could be needed, i.e., twice the sum that was under discussion at the time Ireland and the Commission agreed to the 2014 deadline. We express a concern over the potential negative impact on the economy of this scale of adjustment over this period of time, while accepting that the 2014 deadline is unlikely to be changed.

## NATIONAL ACCOUNTS 2009 (Estimate)

### A: Expenditure on Gross National Product

	2008	2009	Change in 2009				
	€bn	Estimate €bn	Value €bn	Volume	Value	% Price	Volume
Private Consumer Expenditure	94.8	84.3	-10.5	-6.7	-11.1	-4.3	-7.0
Public Net Current Expenditure	29.2	27.7	-1.5	-1.3	-5.1	-0.7	-4.4
Gross Fixed Capital Formation	39.8	24.7	-15.1	-12.3	-37.9	-10.0	-31.0
Exports of Goods and Services (X)	150.2	144.8	-5.4	-6.2	-3.6	0.6	-4.1
Physical Changes in Stocks	0.3	-2.3	-2.6	-2.5			
<b>Final Demand</b>	<b>314.3</b>	<b>279.3</b>	<b>-35.0</b>	<b>-29.0</b>	<b>-11.1</b>	<b>-2.1</b>	<b>-9.2</b>
less:							
Imports of Goods and Services (M)	133.9	120.4	-13.5	-13.0	-10.1	-0.4	-9.7
less:							
Statistical Discrepancy	0.4	-0.7	-1.2	-2.4			
<b>GDP at Market Prices</b>	<b>180.0</b>	<b>159.6</b>	<b>-20.3</b>	<b>-13.6</b>	<b>-11.3</b>	<b>-4.0</b>	<b>-7.6</b>
less:							
Net Factor Payments (F)	-25.3	-28.4	-3.1	-2.9	12.2	0.8	11.3
<b>GNP at Market Prices</b>	<b>154.7</b>	<b>131.2</b>	<b>-23.4</b>	<b>-16.5</b>	<b>-15.1</b>	<b>-5.0</b>	<b>-10.7</b>

### B: Gross National Product by Origin

	2008	2009	Change in 2009	
	€bn	Estimate €bn	€bn	%
Agriculture, Forestry, Fishing	2.9	2.2	-0.7	-24.4
Non-Agricultural: Wages, etc.	79.4	72.7	-6.7	-8.5
Other:	60.5	53.9	-6.5	-10.8
Adjustments: Stock Appreciation	-0.2	1.0		
Statistical Discrepancy	0.4	-0.7		
<b>Net Domestic Product</b>	<b>143.0</b>	<b>129.1</b>	<b>-13.9</b>	<b>-9.7</b>
less:				
Net Factor Payments	-25.3	-28.4	-3.1	12.2
<b>National Income</b>	<b>117.7</b>	<b>100.7</b>	<b>-17.0</b>	<b>-14.5</b>
Depreciation	16.9	14.8	-2.2	-12.8
<b>GNP at Factor Cost</b>	<b>134.6</b>	<b>115.4</b>	<b>-19.2</b>	<b>-14.3</b>
Taxes less Subsidies	20.0	15.8	-4.2	-21.2
<b>GNP at Market Prices</b>	<b>154.7</b>	<b>131.2</b>	<b>-23.4</b>	<b>-15.1</b>

### C: Balance of Payments on Current Account

	2008	2009	Change in 2009
	€bn	Estimate €bn	€bn
Exports (X) less Imports (M)	16	24	8
Net Factor Payments (F)	-25.3	-28.4	-3.1
Net Transfers	-1.2	-0.9	0.3
<b>Balance on Current Account</b>	<b>-10.2</b>	<b>-4.9</b>	<b>5.3</b>
as % of GNP	-6.6	-3.7	2.8

### D: GNDI and Terms of Trade

	2008	2009	2009 Volume Change	
	€bn	Estimate €bn	€bn	%
Terms of Trade Loss or Gain		1.4		
GNP Adjusted for Terms of Trade	154.7	139.5	-15.2	-9.8
GNDI*	153.5	138.6	-14.9	-9.7
National Resources**	153.6	137.4	-16.2	-10.6

\*GNDI is GDP adjusted for terms of trade and net international transfers.

\*\* GNDI including capital transfers.

## FORECAST NATIONAL ACCOUNTS 2010

### A: Expenditure on Gross National Product

	2009 Estimate €bn	2010 Forecast €bn	Change in 2010				
			€bn		%		
			Value	Volume	Value	Price	Volume
Private Consumer Expenditure	84.3	82.2	-2.1	-0.4	-2 ½	-2	- ½
Public Net Current Expenditure	27.7	25.7	-2.0	-0.8	-7 ¼	-4 ¼	-3
Gross Fixed Capital Formation	24.7	17.6	-7.1	-6.3	-28 ¾	-4 ¼	-25 ½
Exports of Goods and Services (X)	144.8	155.7	10.9	10.9	7 ½	0	7 ½
Physical Changes in Stocks	-2.3	-0.1	2.2	1.7			
<b>Final Demand</b>	<b>279.3</b>	<b>281.1</b>	<b>1.9</b>	<b>4.1</b>	<b>¾</b>	<b>- ¾</b>	<b>1 ½</b>
less:	0.0	0.0	0.0	0.0			
Imports of Goods and Services (M)	120.4	124.1	3.7	4.4	3	- ½	3 ½
less:							
Statistical Discrepancy	-0.7	-0.7	0.0	-0.1			
<b>GDP at Market Prices</b>	<b>159.6</b>	<b>157.8</b>	<b>-1.8</b>	<b>-0.2</b>	<b>-1 ¼</b>	<b>-1</b>	<b>- ¼</b>
less:							
Net Factor Payments (F)	-28.4	-30.7	-2.3	-1.7	8 ¼	2	6
<b>GNP at Market Prices</b>	<b>131.2</b>	<b>127.1</b>	<b>-4.2</b>	<b>-1.9</b>	<b>-3 ¼</b>	<b>-1 ¾</b>	<b>-1 ½</b>

### B: Gross National Product by Origin

	2009 Estimate €bn	2010 Forecast €bn	Change in 2010	
			€bn	%
Agriculture, Forestry, Fishing	2.2	2.4	0.2	10
Non-Agricultural: Wages, etc.	72.7	68.3	-4.4	-6
Other:	53.9	57.5	3.5	6 ½
Adjustments: Stock Appreciation	1.0	-0.2		
Statistical Discrepancy	-0.7	-0.7		
<b>Net Domestic Product</b>	<b>129.1</b>	<b>127.2</b>	<b>-1.9</b>	<b>-1 ½</b>
less:				
Net Factor Payments	-28.4	-30.7	-2.3	8 ¼
<b>National Income</b>	<b>100.7</b>	<b>96.4</b>	<b>-4.2</b>	<b>-4 ¼</b>
Depreciation	14.8	14.7	-0.1	- ½
<b>GNP at Factor Cost</b>	<b>115.4</b>	<b>111.2</b>	<b>-4.3</b>	<b>-3 ¾</b>
Taxes less Subsidies	15.8	15.9	0.1	¾
<b>GNP at Market Prices</b>	<b>131.2</b>	<b>127.1</b>	<b>-4.2</b>	<b>-3 ¼</b>

### C: Balance of Payments on Current Account

	2009 Estimate €bn	2010 Forecast €bn	Change in 2010	
			€bn	%
Exports (X) less Imports (M)	24.4	31.6	7.2	
Net Factor Payments (F)	-28.4	-30.7	-2.3	
Net Transfers	-0.9	-0.9	0.0	
<b>Balance on Current Account</b>	<b>-4.9</b>	<b>-0.1</b>	<b>4.8</b>	
as % of GNP	-3.7	-0.1	3.7	

### D: GNDI and Terms of Trade

	2009 €bn	2010 Estimate €bn	2010 Volume Change	
			€bn	%
Terms of Trade Loss or Gain		0.8		
GNP Adjusted for Terms of Trade	131.2	130.2	-1.0	- ¾
GNDI*	130.3	129.3	-1.0	- ¾
National Resources**	130.4	128.1	-2.3	-1 ¾

\*GNDI is GDP adjusted for terms of trade and net international transfers.

\*\* GNDI including capital transfers.



## FORECAST NATIONAL ACCOUNTS 2011

### A: Expenditure on Gross National Product

	2010 Forecast €bn	2011 Forecast €bn	Change in 2011				
			Value	Volume	Value	% Price	Volume
Private Consumer Expenditure	82.2	83.9	1.7	0.8	2	1	1
Public Net Current Expenditure	25.7	24.7	-1.0	-0.8	-4	-1	-3
Gross Fixed Capital Formation	17.6	17.0	-0.6	-0.6	-3 ¾	- ¼	-3 ¼
Exports of Goods and Services (X)	155.7	164.7	9.1	8.5	5 ¾	¼	5 ½
Physical Changes in Stocks	-0.1	0.0	0.1	0.1			
<b>Final Demand</b>	<b>281.1</b>	<b>290.3</b>	<b>9.2</b>	<b>8.2</b>	<b>3 ¼</b>	<b>¼</b>	<b>3</b>
less:							
Imports of Goods and Services (M)	124.1	129.6	5.6	4.7	4 ½	¾	3 ¾
less:							
Statistical Discrepancy	-0.7	-0.7	0.0	0.0			
<b>GDP at Market Prices</b>	<b>157.8</b>	<b>161.4</b>	<b>3.6</b>	<b>3.6</b>	<b>2 ¼</b>	<b>0</b>	<b>2 ¼</b>
less:							
Net Factor Payments (F)	-30.7	-32.6	-1.8	-1.2	6	2	4
<b>GNP at Market Prices</b>	<b>127.1</b>	<b>128.8</b>	<b>1.8</b>	<b>2.4</b>	<b>1 ½</b>	<b>- ½</b>	<b>2</b>

### B: Gross National Product by Origin

	2010 Forecast €bn	2011 Forecast €bn	Change in 2011	
			€bn	%
Agriculture, Forestry, Fishing	2.4	2.5	0.1	5
Non-Agricultural: Wages, etc.	68.3	67.1	-1.2	-1 ¾
Other:	57.5	60.7	3.3	5 ¾
Adjustments: Stock Appreciation	-0.2	-0.2	0.0	0
Statistical Discrepancy	-0.7	-0.7	0.0	0
<b>Net Domestic Product</b>	<b>127.2</b>	<b>129.4</b>	<b>2.2</b>	<b>1 ¾</b>
less:				
Net Factor Payments	-30.7	-32.6	-1.8	6
<b>National Income</b>	<b>96.4</b>	<b>96.8</b>	<b>0.4</b>	<b>½</b>
Depreciation	14.7	15.0	0.3	2
<b>GNP at Factor Cost</b>	<b>111.2</b>	<b>111.8</b>	<b>0.6</b>	<b>½</b>
Taxes less Subsidies	15.9	17.0	1.1	7
<b>GNP at Market Prices</b>	<b>127.1</b>	<b>128.8</b>	<b>1.8</b>	<b>1 ½</b>

### C: Balance of Payments on Current Account

	2010 Estimate €bn	2011 Forecast €bn	Change in 2011 €bn
Exports (X) less Imports (M)	31.6	35.1	3.5
Net Factor Payments (F)	-30.7	-32.6	-1.8
Net Transfers	-0.9	-0.9	0.0
<b>Balance on Current Account</b>	<b>-0.1</b>	<b>1.6</b>	<b>1.7</b>
as % of GNP	<b>-0.1</b>	<b>1.2</b>	<b>1.3</b>

### D: GNDI and Terms of Trade

	2010 €bn	2011 Estimate €bn	2011 Volume Change	
			€bn	%
Terms of Trade Loss or Gain		-0.6		
GNP Adjusted for Terms of Trade	127.1	128.9	1.8	1 ½
GNDI*	126.2	128.0	1.8	1 ½
National Resources**	126.3	128.1	1.8	1 ½

\*GNDI is GDP adjusted for terms of trade and net international transfers.

\*\* GNDI including capital transfers.

# THE INTERNATIONAL ECONOMY

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## Main Developments

The recovery in the world economy strengthened during the second half of 2010 although the outlook remains clouded by a high degree of uncertainty and the uneven nature of the recovery to date. The world economy expanded at an annual rate of 5.3 per cent in the first six months of 2010 according to the latest International Monetary Fund *World Economic Outlook*.<sup>1</sup> This overall performance masks considerable variation in the extent of the economic recovery across different regions. Global growth continues to be powered by the strong recovery in emerging and developing economies, while the recovery in the advanced economies is progressing at a more modest pace in the face of ongoing financial market fragility. In this setting, the world economy is expected to grow by 4.8 per cent in 2010 and by 4.2 per cent in 2011. Growth in the emerging and developed economies is expected to average 6.4 per cent in 2011 while growth in advanced economies is expected to reach 2.2 per cent. This divergent performance reflects the broad-based economic recovery underway in many emerging market economies where the recovery has moved beyond restocking and on to consumption and fixed investment. This has added momentum to the expansion in output created by buoyant export growth. In contrast, the recovery process in place in many advanced economies remains unbalanced as a result of subdued household spending, high unemployment, large budget deficits and ongoing problems in the banking system.

Growth in the US economy moderated sharply during the second quarter of 2010 as the impact of the unprecedented macroeconomic policy stimulus began to wane<sup>2</sup> (Figure 1). The economy grew at an annualised rate of 1.7 per cent in the three months to June, down from 3.7 per cent in the first quarter. The moderation in the growth rate in the second quarter was due to a slowdown in inventory accumulation and sluggish personal consumption – the largest component of US GDP. In contrast, fixed investment rebounded strongly during the second quarter driven by growth in computers and equipment. Looking ahead, it is expected that personal consumption will remain sluggish in the coming quarters as a result of the deterioration in household net worth arising from falling house prices, high

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<sup>1</sup> The international numbers used in this *Commentary* are taken from the October 2010 IMF *World Economic Outlook*.

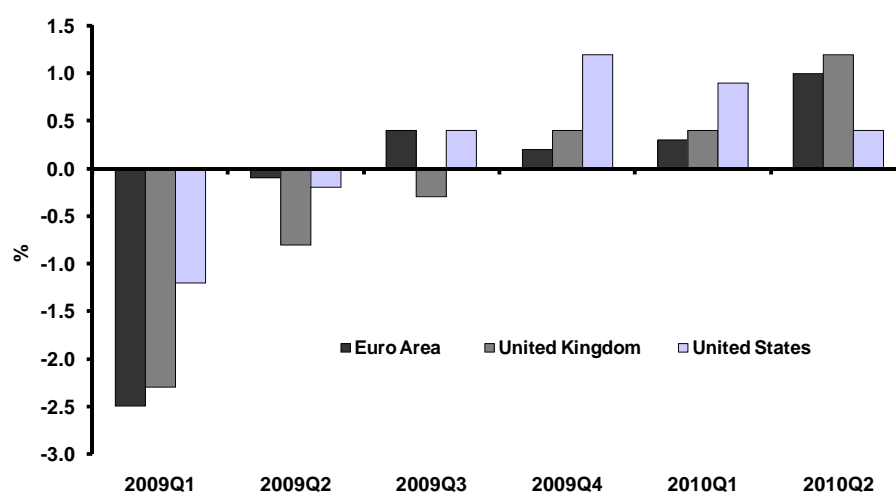
<sup>2</sup> In this section, growth rates which refer to the performance in a particular quarter are seasonally adjusted quarter-on-quarter growth rates.

Source: Eurostat [http://epp.eurostat.ec.europa.eu/cache/ITY\\_PUBLIC/2-06102010-AP/EN/2-06102010-AP-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-06102010-AP/EN/2-06102010-AP-EN.PDF)

unemployment and a weak labour market. Mirroring the situation in Ireland, these concerns have been manifested in an unusually high savings rate; the personal savings rate since early 2009 has averaged 6 per cent, the highest level since 1995. With the impetus to economic recovery provided by fiscal policy and the inventory cycle beginning to subside and consumer spending remaining flat, international forecasters expect the recovery in the US to occur at a slower pace than at the time of the last *Commentary*. US GDP is now expected to increase by 2.6 per cent in 2010 and 2.3 per cent in 2011.

The recovery in the UK economy gathered momentum in the second quarter of 2010, with GDP increasing by 1.2 per cent compared with a 0.3 per cent increase in the first quarter (Figure 1). The rise in GDP between April and June represented the fastest pace of growth since the first quarter of 2001 and was fuelled by particularly strong growth in construction output. Both National Institute of Economic and Social Research (NIESR) (July 2010 *Economic Review*) and the Bank of England, in their most recent *Inflation Report*, have drawn attention to the UK's disappointing trade performance. Despite the substantial depreciation in sterling, net trade is estimated to have made a negative contribution to growth in each of the past three quarters as the economy slowly adjusts to the production of tradable goods and services. Nevertheless, NIESR expect the competitiveness gains from the depreciation of sterling to eventually provide the platform for strong growth in exports. UK growth will be tempered in 2010 and 2011 as a result of the ongoing fiscal consolidation and continued weakness in the supply of credit to the private sector. NIESR estimate that the measures introduced in the emergency budget in June will reduce the growth rate by 0.4 per cent in 2011. The further adjustments expected in the forthcoming budget are also likely to act as a drag on growth next year. Overall, the IMF anticipates that the UK economy will expand by 1.7 per cent in 2010 and 2 per cent in 2011.

**Figure 1: Quarter-on-Quarter GDP Volume Growth (%), Seasonally Adjusted**



Source: Eurostat.

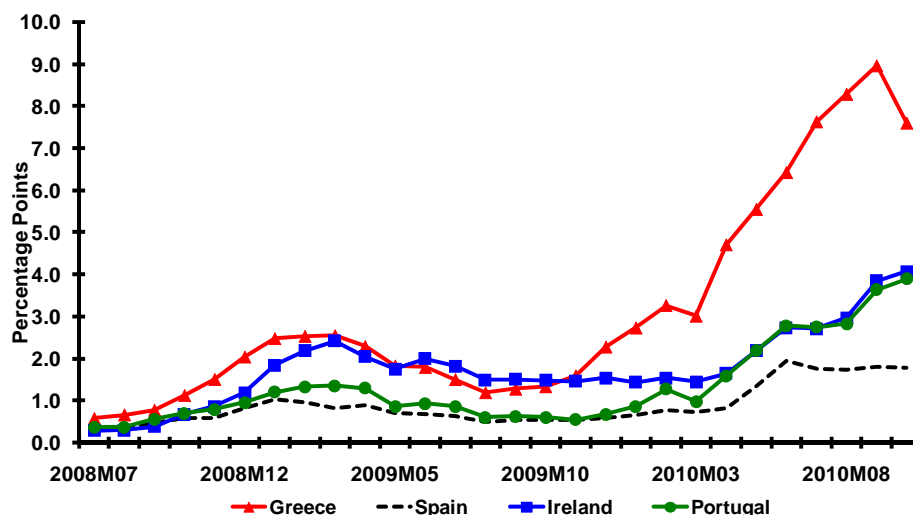
Despite a sharp acceleration in the pace of growth during the second quarter, there are few signs that the Euro Area economy has yet entered a broad-based and self-sustaining recovery phase. While Euro Area GDP increased by 1 per cent in the second quarter, there were pronounced differences in economic performance recorded across the region. The expansion in the three months to June 2010 was driven largely by vigorous growth in the German economy, strong export growth and a temporary boost to construction output related to the adverse weather conditions in the early part of 2010. Growth in the Euro Area's other large economies such as France and Italy remains modest as a result of weak private consumption, high unemployment and the withdrawal of stimulus measures introduced in the wake of the financial crisis. Growth in other economies including Greece, Ireland, Portugal and Spain is being held back as a result of the implementation of fiscal austerity measures as well as competitiveness imbalances. The robust performance of Germany's manufacturing exports is expected to be moderated by this weak demand among its trading partners. Against this backdrop, the recovery in the Euro Area is projected to continue at a modest pace. The IMF expects GDP to expand by 1.7 per cent in 2010 and 1.5 per cent in 2011.

While the global economic recovery continued during the first half of 2010 at a more impressive pace than had earlier been anticipated by many forecasters, in an environment of elevated risk, potential obstacles exist which could derail the nascent economic recovery currently underway. In the Euro Area, the unwinding of exceptional fiscal stimulus packages, concern over public debt sustainability and a fragile financial sector are all adversely affecting economic performance. The turmoil in sovereign debt markets during the second quarter of 2010, arising from the Greek crisis, has already caused severe disruption to the normal functioning of European financial markets. The stress tests conducted by the Committee of European Banking Supervisors brought about some improvement in market conditions in recent months. However, European banks remain heavily dependent on the European Central Bank financing facilities and have significant exposure to sovereign debt which increases the vulnerability of the European financial sector to future shocks.

Contagion from the financial instability during the second quarter of 2010 added to existing concerns regarding public debt sustainability. For many European economies, the task of restoring order to the public finances remains a prerequisite for a return to healthy growth. Chastened by the lessons from the Greek crisis, many European governments are in the process of implementing fiscal consolidation plans. However, as shown in Figure 2, government bond yields remain elevated in some of the Euro Area's peripheral economies reflecting ongoing market concerns regarding debt sustainability. The precarious position of some European countries in sovereign debt markets could act as a drag on economic recovery if, as noted in the IMF's *Global Financial Stability Report*, public debt issuance crowds out private sector credit growth leading to an increase in the cost of borrowing for the private sector. This highlights the necessity for high risk countries to produce and implement credible fiscal consolidation plans or face a further loss of investor confidence and a further increase in interest rates. At the same time, the implementation of

deep budgetary cuts over the coming years will weigh on growth in the Euro Area and inhibit the recovery in private demand necessary to create and sustain growth.

**Figure 2: Ten Year Government Bond Spreads Relative to Germany  
(July 2008 – 11 October 2009)**



Source: Datastream.

The current state of the US economy represents another downside risk to the recovery in the international economy. Slower than expected consumer spending as well as continued weakness in residential and non-residential construction has stifled the recovery in US output and employment. In response to these concerns, the Federal Reserve has announced its intention to hold US interest rates at their current exceptionally low levels, using a variety of tools, while standing ready to deploy other exceptional monetary policy options to provide additional stimulus if needed. In previous *Commentaries* we have noted the argument put forward by commentators such as Olivier Blanchard, Chief Economist at the International Monetary Fund (IMF), that premature fiscal tightening, by countries where debt sustainability is not in question, could jeopardise the economic recovery. In a recent speech, Adam Posen<sup>3</sup> has argued that premature withdrawal of accommodative monetary policies also poses a serious threat to achieving a sustained economic recovery. Posen believes that further unconventional monetary stimulus is needed to avoid persistent high unemployment and low growth in the years ahead. While monetary policy is likely to remain highly accommodative over the short term, designing appropriate exit strategies from the exceptional policy measures introduced during the crisis will be one of the key priorities for governments and policymakers over the coming year. The challenge of determining the appropriate stance of monetary policy, so as to avoid undermining the fragile recovery currently underway, while at the same

<sup>3</sup> Adam Posen is an external member of the Bank of England's Monetary Policy Committee.

Source: <http://www.bankofengland.co.uk/publications/speeches/2010/speech449.pdf>

time guarding against inflationary pressures is discussed in a recent paper by David Miles.<sup>4</sup>

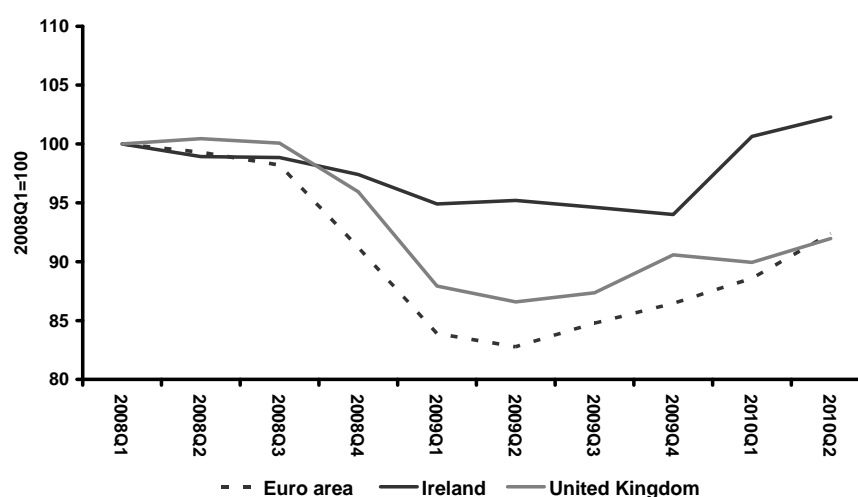
## Implications for Ireland

### EXPORTS

As discussed in previous *Commentaries* and in Bergin *et al.* (2010)<sup>5</sup>, we see the recovery in the Irish economy being driven by an expansion in Irish exports of goods and services. The recent performance of exports provides reassurance that the recovery in the Irish economy can be export-led. Irish exports have proven to be relatively resilient during the recession and the magnitude of the decline was much less severe than that experienced by other advanced economies (Figure 3). During the second quarter of 2010, exports of goods and services increased by 7.4 per cent compared to the first quarter.

Ireland's future export performance will be determined by the extent to which the economy can regain competitiveness through reductions in wage rates and other costs as well as the level of world demand. For 2010, we expect price inflation here to be lower than in the UK and in the Euro Area with positive implications for competitiveness. For 2011, we again expect HICP inflation in Ireland to be lower than that expected for the Euro Area and the UK. Regarding wage rates, NIESR estimate that average earnings in the Euro Area increased by 1.7 per cent in 2009 with further increases of 1.8 per cent and 2.6 per cent anticipated in 2010 and 2011. As discussed below in the *Incomes* section, we estimate that an economy-wide wage reduction of 1 per cent occurred last year with further reductions in wage rates of 3 per cent expected in 2010 and 2011.

**Figure 3: Volume Exports of Goods and Services, Quarter-on-Quarter Percentage Change, Seasonally Adjusted**



Source: Eurostat

<sup>4</sup> Miles, D., 2010. "Monetary Policy and Financial Stability" in *Budget Perspectives 2010*, ESRI. <http://www.esri.ie/UserFiles/publications/RS18/RS18.pdf>

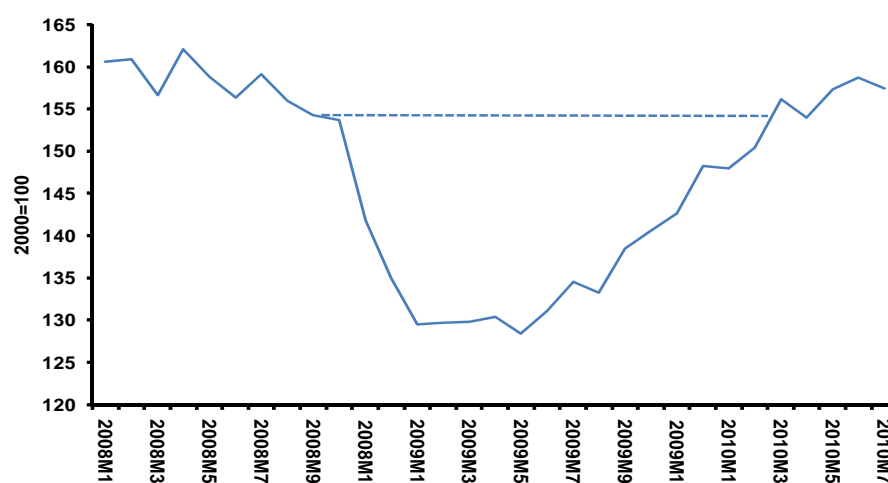
<sup>5</sup> Bergin, A., Conefrey, T., Fitz Gerald, J., and Kearney, I. 2010. *Recovery Scenarios for Ireland: An Update*. Economic and Social Research Institute, Dublin.



A new experimental release by the CSO, the *Services Producer Price Index*,<sup>6</sup> sheds some further light on the extent of the competitiveness adjustment currently underway in the Irish economy. The most recent release indicates that services prices fell by 3.6 per cent in the second quarter of 2010 compared to Q2 2009. The largest declines were recorded in architecture, engineering and technical testing (-8 per cent), computer programming and consultancy (-6 per cent) and warehousing and storage (-6 per cent). Taken together, these developments in prices, wages and other costs (including the sharp fall in the cost of housing) imply that the Irish economy should regain some of the competitiveness lost in the years preceding the current crisis.

As noted, the outlook for Irish exports over the forecast horizon depends crucially on the international recovery. World trade has rebounded strongly following the collapse which occurred towards the end of 2008 and has now exceeded pre-crisis levels (Figure 4). World trade is expected to grow by 16.5 per cent in 2010 but is likely to moderate sharply in 2011 unless a strong pick-up in consumer spending takes hold. Despite this, the international environment for Irish exports should be favourable in 2011 if the growth rates currently forecast by the IMF for the UK, US and Euro Area materialise.

**Figure 4: Index of World Trade**



Source: World Trade Monitor, Centraal Planbureau (The Netherlands).

## EXCHANGE RATES

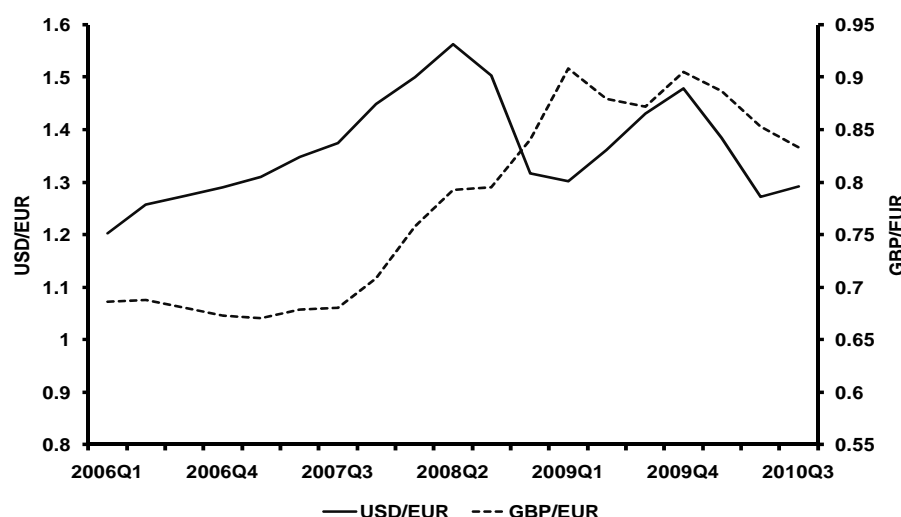
Related to the issue of competitiveness and the outlook for Irish exports are the expected developments in bilateral exchange rates. As with the other international numbers used in this *Commentary*, the exchange rates are taken from the most recent IMF *World Economic Outlook*. The IMF assumes that exchange rates will remain constant at their average levels during the period August 4 – September 10, 2010. These assumptions imply that the

<sup>6</sup> The experimental *Services Producer Price Index* (SPPI) measures changes in the average prices charged by domestic service producers to other businesses for a selected range of services. The indices are still under development and may be subject to revisions following methodological improvement.

sterling/euro exchange rate will average 0.85 in 2010 and 0.83 in 2011, while the USD/EUR exchange rate will average 1.31 in 2010 and 1.28 in 2011.

The crisis in Greece as well as wider concerns regarding public debt sustainability in a number of other peripheral Euro Area countries gave rise to a substantial fall in the value of the Euro against both the UK pound and the dollar during the second quarter of 2010 (Figure 5). The euro fell to a four year low of \$1.19 against the dollar and an eighteen month low of £0.82 against the pound in June this year. The agreement between the EU and the IMF to create the European Financial Stability Facility as well as the strong rise in Euro Area GDP in the second quarter has seen the Euro recently reclaim some of the ground lost in the early part of 2010, although its value remains well below the heights reached against both the dollar and the pound in 2007-2008 period. Were this position to be maintained in 2011, and if the assumptions on exchange rates for 2011 prove to be correct, it should benefit the Irish economy by providing a boost to exports outside the Euro Area.

**Figure 5: Exchange Rates**



Source: Central Bank.

## INTEREST RATES

The ECB main refinancing rate was reduced rapidly from 3.75 per cent in October 2008 to an all time low of 1 per cent in May 2009 (Figure 6). The Euro Area emerged from recession during the second half of 2009, although the pace of growth has so far been moderate and unbalanced as discussed above. The return to growth in the Euro Area is not expected to put significant upward pressure on inflation over the forecast horizon as private demand and hence domestic price pressures remain subdued. The ECB has consistently stated that the current interest rates and the accommodative monetary policy stance are appropriate. With inflation rates expected to remain moderate in 2011, it appears unlikely that the ECB will consider raising interest rates until the second half of 2011. As a result, our forecasts are based on the assumption that the main refinancing rate will be held at 1 per cent for the remainder of 2010, rising to 1.25 per cent by the end of 2011.

**Table 1: Short term International Outlook**

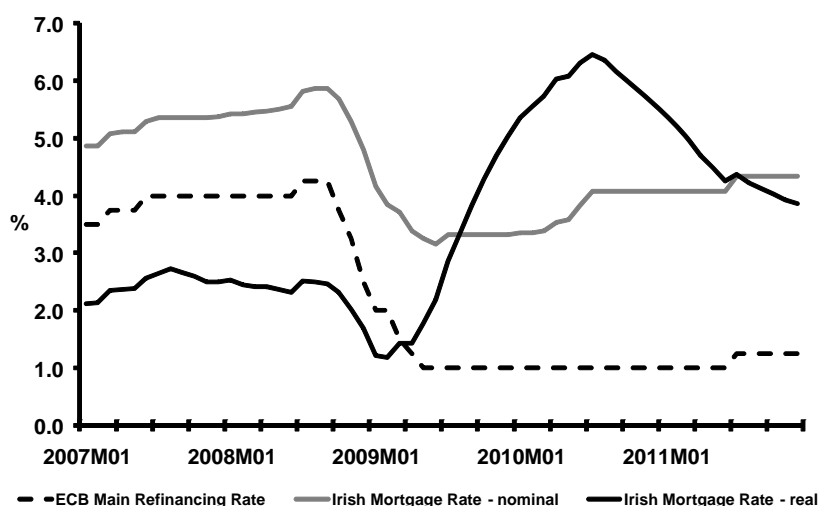
Country	GDP Output Growth			Consumer Prices* Inflation			Unemployment Rate			General Government Balance % of GDP		
	%			%			%					
	2009	2010	2011	2009	2010	2011	2009	2010	2011	2009	2010	2011
UK	-4.9	1.7	2.0	2.1	3.1	2.5	7.5	7.9	7.4	-10.3	-10.2	-8.1
Germany	-4.7	3.3	2.0	0.2	1.3	1.4	7.5	7.1	7.1	-3.1	-4.5	-3.7
France	-2.5	1.6	1.6	0.1	1.6	1.6	9.4	9.8	9.8	-7.6	-8.0	-6.0
Italy	-5.0	1.0	1.0	0.8	1.6	1.7	7.8	8.7	8.6	-5.2	-5.1	-4.3
Euro Area	-4.1	1.7	1.5	0.3	1.6	1.5	9.4	10.1	10.0	-3.1	-4.5	-3.7
USA	-2.6	2.6	2.3	-0.3	1.4	1.0	9.3	9.7	9.6	-12.9	-11.1	-9.7
Japan	-5.2	2.8	1.5	-1.4	-1.0	-0.3	5.1	5.1	5.0	-10.2	-9.6	-8.9
China	9.1	8.5	9.0	5.9	-0.1	0.6	9.8	7.8	8.6			
OECD	-3.2	2.7	2.2	0.1	1.4	1.3	8.0	8.3	8.2	-10.1	-9.3	-8.0
Ireland	-7.6	- ¼	2 ¼	-1.7	-1 ½	½	11.8	13 ¼	13 ½	-14.6	-31	-10

*Source:* Source: IMF World Economic Outlook, October 2010.

\*HICP for EU countries, consumption deflator for rest of world.

The persistence of low interest rates and the accommodative stance of monetary policy more broadly are welcome developments for Ireland given the ongoing weaknesses in the economy and the fragile state of the banking sector. High ECB interest rates in addition to the current high risk premium attached to Irish government debt, would clearly pose a significant challenge to economic recovery. Low ECB interest rates should provide a supportive environment for households and businesses that are currently in the process of repairing their balance sheets, notwithstanding the increases in interest rates which have taken place independent of changes in the ECB rate shown in Figure 6. Moreover, the provision of liquidity by the ECB to the banking system, through the implementation of non-standard monetary policy measures such as Longer-Term Refinancing Operations (LTROs), has been crucial in easing financial market tensions. As discussed further in the *Monetary Sector Developments* section, Irish banks have had particularly intensive recourse to the facilities provided as part of the ECB's monetary policy operations. This support will remain important in the light of the challenging conditions still facing Irish banks in international financial markets.

**Figure 6: Interest Rates**



Source: CSO, ECB and own forecasts

# THE DOMESTIC ECONOMY

In this *Quarterly Economic Commentary* our growth forecasts for 2011 are revised downwards relative to the *Summer Commentary*. We now forecast GDP to grow by 2¼ per cent, a downward revision of ½ a percentage point. There are two main reasons for this revision. The first is related to poor consumer confidence. Given the turmoil surrounding the Irish sovereign debt market in recent months, the latest estimates of the cost of the bank bailout, and the likelihood of a larger than anticipated fiscal correction in the December budget, it is not surprising that consumer confidence has remained sluggish. Nevertheless, without a resumption of strong consumption growth, it will be difficult to achieve a broad-based recovery in the economy. The second reason why we expect growth to be lower in 2011 is related to the budget. We assume in this *Commentary* that the budgetary cuts for 2011 will be at least €1 billion higher than in the *Summer Commentary*, thereby leading to lower consumption spending and lower disposable incomes.

Table 2 shows the implied carryover figures from the most recent *QNA* data. Carryover is the annual change in a variable if it were to remain at its level in the last known quarter. This essentially measures the impact of past changes; it is not a forecast. Were economic activity to remain unchanged from the level recorded in the second quarter of 2010 then GDP would contract by 1 per cent in 2010. However, we expect some pick-up in economic activity through the second half of 2010, in particular in consumption, so that our forecast suggests GDP will fall by just ¼ per cent in 2010. In 2011, we anticipate that a further tight budget will keep consumption growth modest at 1 per cent, and also further depress investment.

Despite poor prospects in relation to domestic consumption over the short term, the latest data suggest that the Irish traded sector has grown very strongly in the first half of 2010. While we expect this very strong bounce-back effect to moderate in the second half of the year, we have nevertheless revised upwards our forecast for growth in the industrial sector and our estimates of exports growth. The most recent data indicate clearly that the export sector is out of recession and likely to grow strongly in 2010 and 2011. These forecasts are based on the expectation among international forecasters that growth in the world economy will recover during 2010, picking up further in 2011.

**Table 2: Implied Carryover from Quarterly National Accounts Q2,  
Constant Price Growth Rates**

		<b>QNA Q2 Carryover</b>	<b>QEC Forecast</b>	
	<b>2009</b>	<b>2010</b>	<b>2010</b>	<b>2011</b>
Private Consumption	-7.0	-1.1	- ½	1
Government Consumption	-4.4	-2.8	-3	-3
Investment	-31.0	-17.6	-25 ½	-3 ¼
Exports	-4.1	7.6	7 ½	5 ½
Imports	-9.7	5.7	3 ½	3 ¾
GDP at market prices	-7.6	-0.8	- ¼	2 ¼
GNP at market prices	-10.7	-3.4	-1 ½	2
<b>Sectoral Output</b>				
GDP at factor cost	-5.0	0.0	-¼	2¼
Agriculture Forestry and Fishing	-3.6	1.6	5	2
Distribution Transport and Communications	-9.3	0.0	0	2
Public Administration and Defence	-0.5	-3.0	-3	-2
Other Services (including Rent)	-2.3	-1.6	-¼	2
Industry – Building and Construction	-31.4	-26.6	-31½	-8
Other Industry	-0.1	10.7	7	5

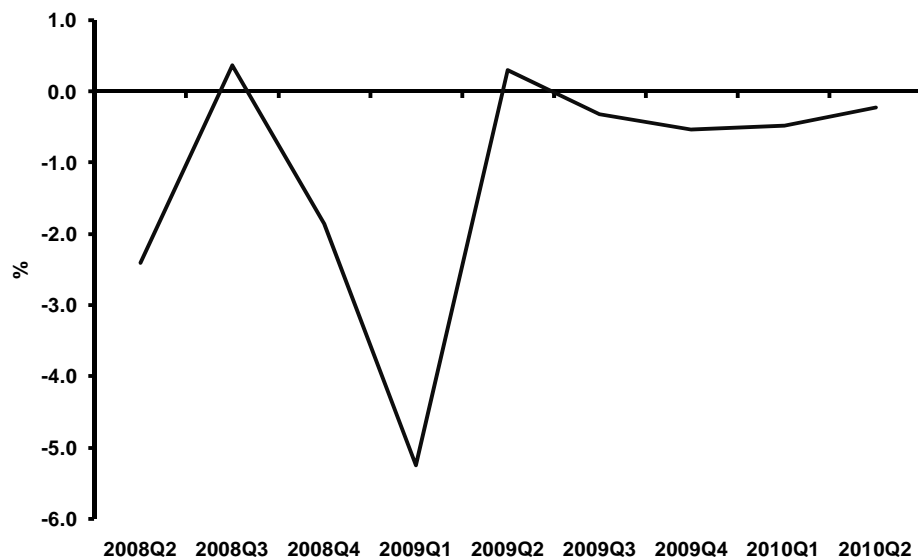
The most recent announcements by the Minister for Finance signalled that the government will be injecting €30.7 billion into Anglo Irish Bank and Irish Nationwide Building Society in 2010. This will result in a General Government Deficit as a percentage of GDP of 31 per cent. Excluding the once-off costs of the banks, the figure would be 11½, as forecast in the Winter 2009 *Commentary*. We have assumed a stylised budget of €4 billion in cuts, we estimate this could reduce the deficit to 10 per cent in 2011. In relation to the labour market, our forecast of unemployment for 2011 is slightly higher than in the previous *Commentary* at 13½ per cent, reflecting the impact of higher budgetary cuts and somewhat higher employment losses in the banking sector in 2011.

## Consumption

The latest *Quarterly National Accounts* (QNA Q2 2010) reveal that consumption has continued to fall in 2010, albeit at a much reduced pace compared to last year. Consumption fell by -1.7 per cent in Q2 2010 compared to Q2 2009, whereas the fall between Q2 2009 and Q2 2008 was -6.5 per cent. In Figure 7, the seasonally adjusted quarter-on-quarter changes in consumption over the past two years are presented. The pace of decline has moderated significantly compared to the dramatic slump in consumption witnessed in Q1 2009. However, the continuing negative trend means that consumption, seasonally adjusted, was 8 per cent lower in Q2 2010 than it was in Q4 2008.



**Figure 7: Quarter-on-Quarter Percentage Change in Volume of Consumption, Seasonally Adjusted**



Source: Quarterly National Accounts, CSO.

Table 3 shows a range of measures that track the recent trends in consumption spending. These figures are consistent with the picture painted above of ever-weakening domestic consumer spending. The annualised change in vehicle sales was down -8.1 per cent, which is a much reduced rate of decline, perhaps resulting from the government scrappage scheme. The decline in retail sales more generally has also moderated significantly. However, Irish people are taking fewer trips abroad, and there is no sign of this pattern abating.

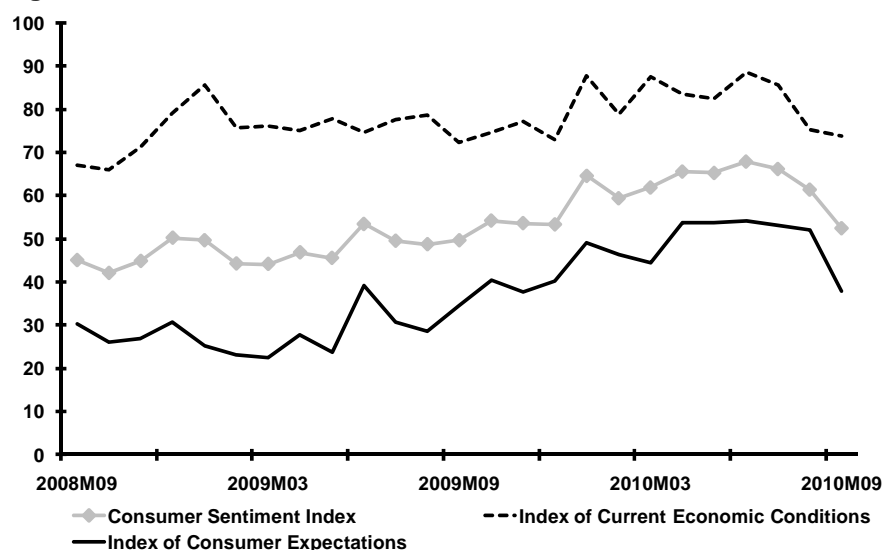
**Table 3: Recent Indicators of Consumption (Annualised Growth Rates)**

	Retail Sales (unadjusted)		Trips Abroad	New Vehicle Sales	All Vehicle Sales
	All Businesses	Excl Motor Trade			
	%	%	%	%	%
2009 Q1	-11.4	-5.0	-3.1	-31.9	-44.7
2009 Q2	-13.1	-6.6	-5.0	-37.3	-53.3
2009 Q3	-14.1	-6.9	-9.6	-46.1	-62.2
2009 Q4	-14.0	-6.9	-10.5	-47.1	-62.5
2010 Q1	-8.6	-5.8	-9.2	-32.1	-38.8
2010 Q2	-4.3	-3.8	-10.4	-18.0	-8.1

The KBC/ESRI Consumer Sentiment Index has fallen from a height of 67.9 in July to 52.4 in September. This corresponds with a rating of 49.6 in September 2009. It would appear that the uncertainty surrounding the fate of the Irish banking sector and the increased awareness surrounding the fiscal condition, coupled with ongoing increases in unemployment, have

lowered consumers' expectations of their future financial situation, as shown in Figure 8.

**Figure 8: KBC/ESRI Consumer Sentiment Index**



Source: Consumer Sentiment Index, KBC Ireland and ESRI

Our estimate for consumption in 2010 is for a fall of  $-\frac{1}{2}$  per cent. This is a downward revision of our previous estimates, driven by weak consumption in Q2. The forecast for 2011 has also been revised downwards to a 1 per cent increase. This downward revision is driven by the larger fiscal austerity measures assumed in this *Commentary*, higher unemployment numbers and a greater degree of uncertainty. Continued weakness in consumption is expected to lead to a correspondingly robust savings rate, which is forecast to rise to  $10\frac{1}{4}$  per cent in 2011.

Consumer sentiment is a nebulous concept, and is one that is not easy to target with policy measures. Domestic spending is inversely related to the level of uncertainty surrounding both the cost of rescuing the banking system and the size and shape of future government austerity measures. Arguably the multi-annual budgetary framework could reduce uncertainty surrounding the latter.

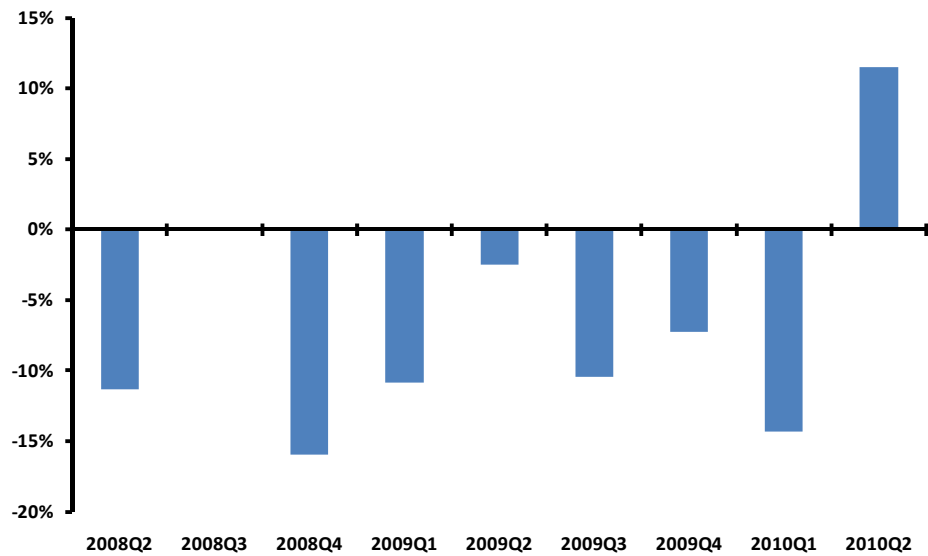
## Investment

Investment in the economy grew by  $11\frac{1}{2}$  per cent in Q2 2010, according to the latest data from the *Quarterly National Accounts*, as shown in Figure 9. This is the first quarterly increase in investment since Q3 2008, albeit from a much reduced base. This expansion can be accounted for by a marked rise in spending on aircraft in Q2 2010, which amounted to €1.2 billion. Investment in machinery and equipment increased by  $1\frac{1}{2}$  per cent in Q2 2010 compared to the same period in 2009, however, this figure falls to  $-9\frac{1}{2}$  per cent when investment in airplanes is excluded. Gross fixed capital investment in other areas of the economy has remained weak. Investment in dwellings was down 44 per cent in Q2 2010 compared to Q2 2009, while other buildings and construction fell by 29 per cent over the same period. Figure 10 charts the general decline in investment over the past two years.

**Table 4: Gross Fixed Capital Formation**

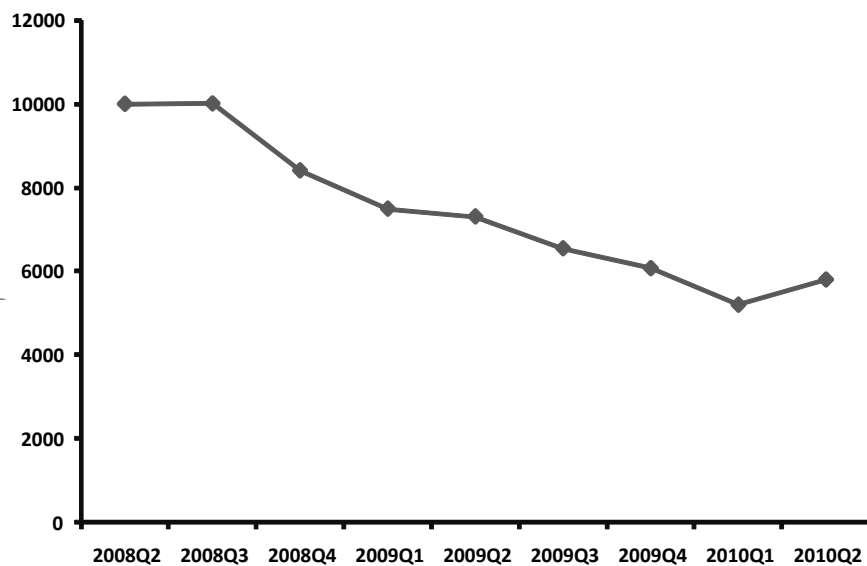
	2008	% Change in 2009		2009	% Change in 2010		2010	% Change in 2011		2011
	₪bn	Volume	Value	₪bn	Volume	Value	₪bn	Volume	Value	₪bn
Housing	15.1	-41.0	-51.2	7.4	-38 ¾	-42	4.3	-5 ¼	-8 ¼	3.9
Other Building	12.9	-24.3	-33.1	8.6	-25	-32 ½	5.8	-10	-12 ¾	5.1
Transfer Costs	1.7	-62.4	-65.7	0.6	-50	-60	0.2	-10	-15	0.2
Building and Construction	29.7	-34.9	-44.2	16.6	-32 ¼	-37 ¾	10.3	-8	-11	9.2
Machinery and Equipment	10.1	-19.3	-19.4	8.1	-10	-10 ½	7.3	5	6 ¾	7.8
<b>Total</b>	<b>39.8</b>	<b>-31.0</b>	<b>-37.9</b>	<b>24.7</b>	<b>-25 ½</b>	<b>-28 ¾</b>	<b>17.6</b>	<b>-3 ¼</b>	<b>-3 ¾</b>	<b>17.0</b>

**Figure 9: Quarter-on-Quarter Percentage Change in Investment, Seasonally Adjusted**



Source: Quarterly National Accounts, CSO.

**Figure 10: Investment, €millions**

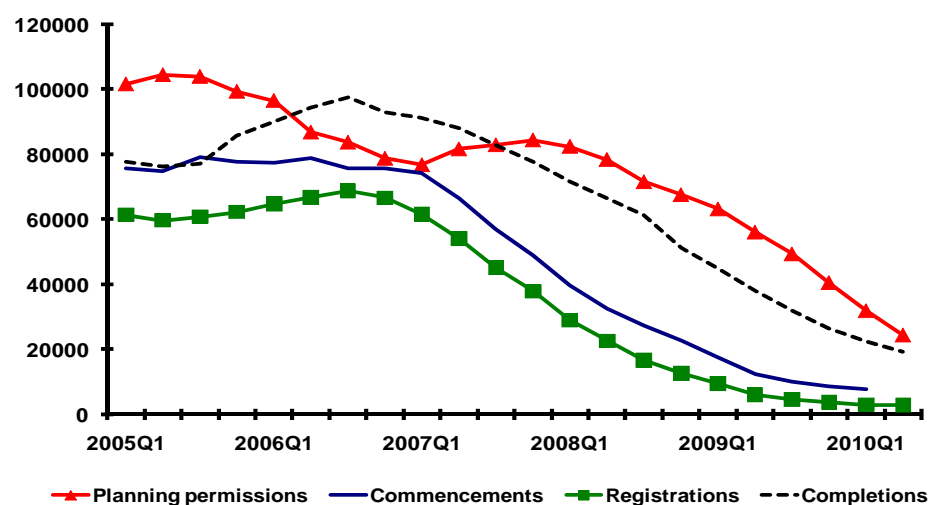


Source: Quarterly National Accounts, CSO.

As can be seen in Figure 11, the contraction in the housing market continued in Q2 2010. On an annualised basis, permissions granted for new houses and apartments were 44 per cent lower in Q2 2010 than in Q2 2009, while housing completions were down 49 per cent. Data from the Department of the Environment, Heritage and Local Government reveal that there were 2,990 commencements in the first five months of the year, compared to 3,970 commencements over the same period in 2009. In relation to completions, we have revised upwards our estimate for house completions in 2010, from 10,000 to 12,000. This revision is largely driven by the latest data on completions: for the first seven months of 2010 just over 9,500 houses have been completed so that despite the very low levels of commencements, it is likely that recorded completions will total

approximately 12,000. Our forecast for 2011 remains unchanged at 10,000 house completions.

**Figure 11: Housing Statistics, Annualised, Number**



Source: CSO and Department of the Environment, Heritage and Local Government.

Turning to house prices, the *permanent tsb/ESRI House Price Index* shows that the pace of decline in national house prices has eased in the second quarter of the year, falling by 1.7 per cent. This compares to a fall of 4.8 per cent in Q1 2010 and a fall of 3.9 per cent in Q2 2009. The cumulative reduction in house prices since their peak in early 2007 is now 35 per cent, while house prices are 44 per cent below their peak in Dublin. Underlying our forecast for the housing deflator is an assumption that new house prices could fall by up to 50 per cent from peak by the end of 2011.

Total building and construction is expected to contract by 32¼ per cent this year, which is similar to the reduction experienced by this sector in 2009. Investment in machinery and equipment is expected to fall by 10 per cent in 2010. These combined decreases mean that total investment is estimated to fall by 25½ per cent in 2010. For 2011, we forecast that the decline will begin to level off, with total investment falling by 3¼ per cent. Underlying this is a forecast of the building and construction sector falling by a further 8 per cent, and machinery and equipment growing by 5 per cent.

### Box 1: The Ratio of House Prices to Rent

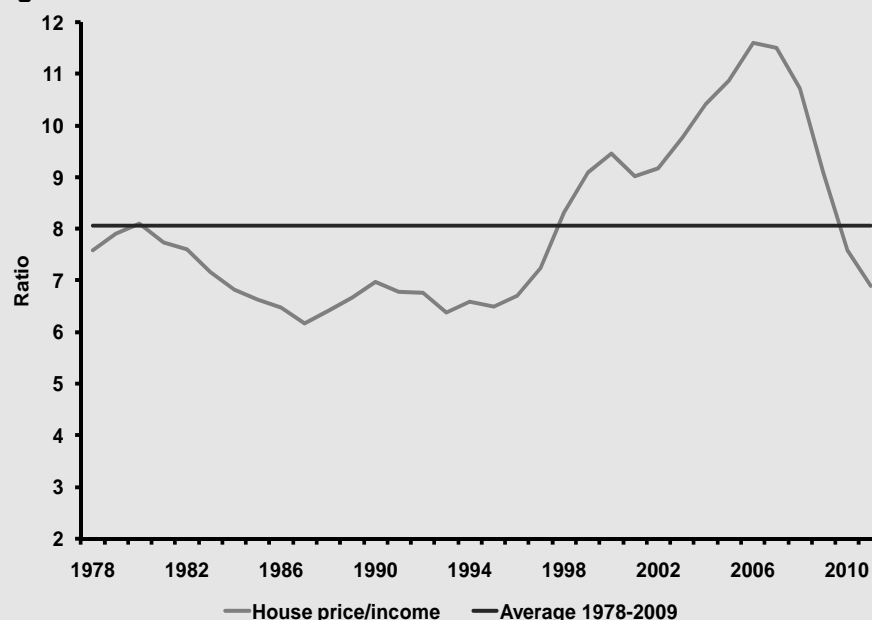
By David Duffy

The forecasts in this *Commentary* suggest that house prices will fall by 50 per cent from their peak in early 2007. This means that in 2011 we expect house prices to average €185,000 in the year.

The house price to rent ratio provides a means of comparing the cost of alternative types of housing tenure. In the long run these tend to move together. Figure 1A plots the ratio of an index of new house prices to the CSO's private rent index. The ratio of house prices to rents rose sharply for most of the period after the mid-1990s as house prices increased at a faster pace than rents. Indeed, since the mid-1990s the ratio has been consistently above its long run average. However, having peaked in 2006 the ratio has

been declining rapidly, and is now back at levels last seen in the late 1990s. Even allowing for the further falls in house prices in 2010 and 2011 and an increase in rents based on the annual average between 1978 and 2009, the ratio of house prices to rents remains above its long run average.

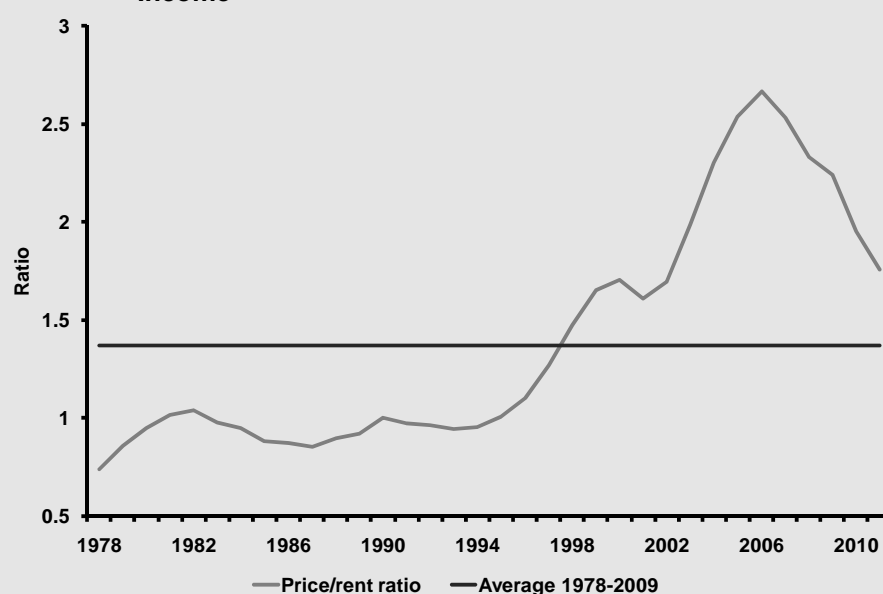
**Figure 1A: New House Price to Private Rents Ratio**



*Source:* New House Prices from the Department of the Environment, Heritage and Local Government. Private rents from CSO databank. 2010 and 2011 forecasts from this *Commentary*.

Over the course of the boom the ratio of house prices to income also rose dramatically. The forecasts for house prices and incomes in this *Commentary* imply that the decline in this ratio will continue in 2010 and 2011 (Figure 1B).

**Figure 1B: Ratio of New House Prices to Personal Disposable Income**

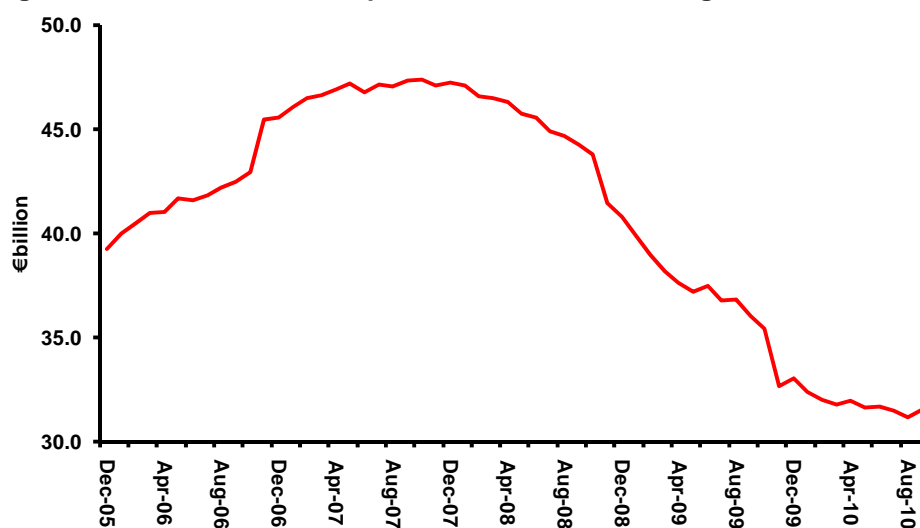


*Source:* New House Prices from the Department of the Environment, Heritage and Local Government. Personal disposable income from ESRI model databank.



The September exchequer returns suggest that the collapse in tax revenues which began in 2008 has ended. On a rolling annual basis, total exchequer tax revenues have since March shown signs of levelling off at around €31.5 billion (Figure 12).<sup>7</sup> Using this measure across all the main tax revenue categories, the data suggest that there are clear signs of stabilisation since the early part of 2010 in VAT, corporation tax and transaction taxes (stamps, capital gains and capital acquisitions). The exception to this pattern is income tax returns, where the annualised total fell continuously up to August 2010. The September returns indicated an increase in income tax in that month relative to September 2009, a positive sign, however, one month's returns is not as yet sufficient to conclude that income tax returns have stabilised.

**Figure 12: Annualised Exchequer Tax Returns on Rolling Basis**



Source: Department of Finance.

Figure 13 shows the exchequer returns for the nine months to September from 2005 to 2010. Total tax revenue in the nine months to September 2010 was €9.3 billion lower than in 2007. This is largely driven by a fall in VAT of €3.6 billion, a fall in transactions taxes of €3 billion and a fall in income tax of €1.5 billion. Tracking total tax revenue against voted expenditure<sup>8</sup> the gap has stabilised in September 2010 relative to September 2009. We expect this to continue for the remainder of 2010 with total exchequer tax revenue estimated at just over €32 billion. Assuming voted expenditure comes in on target, despite capital expenditure in September being almost €1 billion below target, this would mean that the gap between exchequer tax revenue and voted expenditure in 2010 will be €14 billion, the same as in 2009.

<sup>7</sup> A rolling annual measure is a useful metric for tracking the influence of monthly returns while discounting seasonal effects which are often very large in tax returns.

<sup>8</sup> Voted expenditure excludes, among other things, once-off payments into the National Pension Reserve Fund or Anglo Irish Bank.

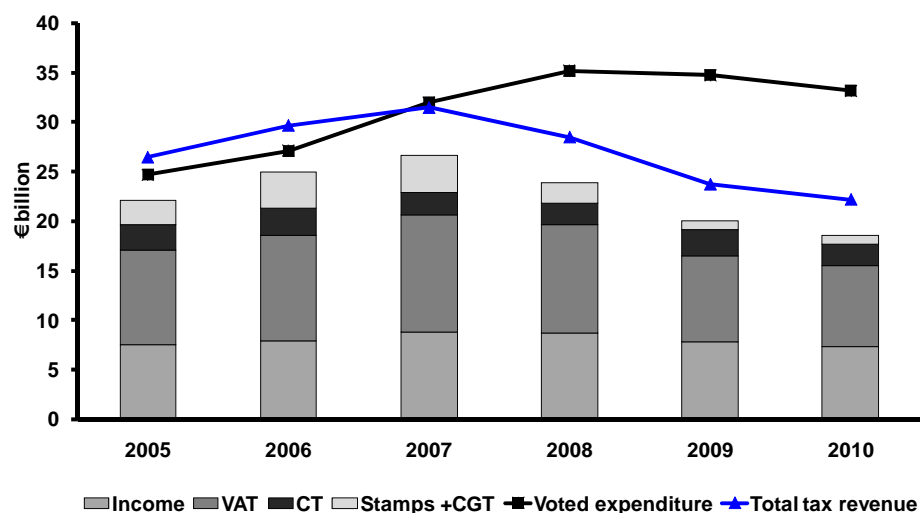
**Table 5: Public Finances**

	2008 €bn	% Change	2009 €bn	% Change	2010 €bn	% Change	2011 €bn
Current Revenue	41.6	-18.6	33.9	2¼	34.7	½	34.8
<i>of which: Tax Revenue</i>	40.8	-19.0	33.0	-2¼	32.3	4½	33.7
Current Expenditure	44.7	1.2	45.2	5¼	47.6	2¼	48.7
<i>of which: Voted</i>	40.8	-1.2	40.3	0	40.3	¼	40.4
<b>Current Surplus</b>	-3.1		-11.4		-12.9		-13.9
Capital Receipts	1.4	4.8	1.5	14¼	1.7	-2½	1.6
Capital Expenditure	11.0	33.5	14.7	-53¾	6.8	29¾	8.8
<i>of which: Voted</i>	8.6	-19.3	6.9	-13¼	6.0	-16¼	5.0
<b>Capital Borrowing</b>	-9.6		-13.3		-5.2		-7.2
<b>Exchequer Balance</b>	-12.7		-24.6		-18.1		-21.1
as % of GNP	-8.2		-18.8		-14¼		-16¼
<b>General Government Balance*</b>	-13.2		-23.4		-48.9		-16.1
as % of GDP	-7.3		-14.6		-31		-10
<b>Gross Debt as % of GDP</b>	44.4		65.6		97¼		105
<b>Net Debt as % of GDP**</b>	22.6		38.2		67¾		74¾

2010 and 2011 figures are based on National Accounts estimates.

\*\*Net of NPRF, Social Insurance and Exchequer Balances.

**Figure 13: Exchequer Returns, Year Ended September**



Source: Department of Finance.

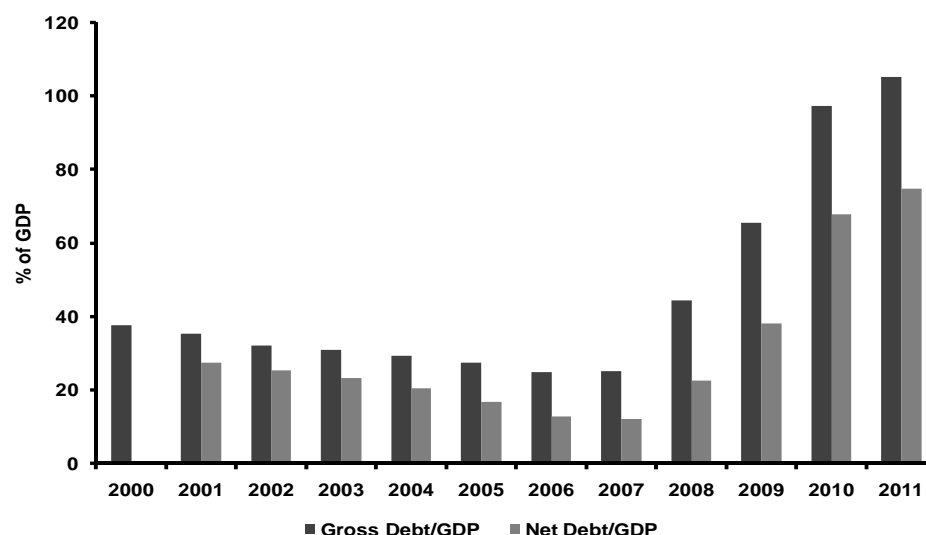
Despite the stabilisation of this deficit, the General Government Deficit in 2010 is likely to reach 31 per cent of GDP. It is very important to understand the composition of this figure. This figure includes the most recent estimate announced by the Minister for Finance on 30 September 2010, stating that the total cost of the bank bailout monies for Anglo Irish Bank (€29.3 billion) and Irish Nationwide Building Society (€5.4 billion)

will total €34.7 billion. Of these monies €4 billion was injected in Anglo Irish Bank in 2009 and is included in the 14.6 per cent deficit in that year. Excluding the cost of Anglo, the underlying deficit for 2009 would be approximately 12 per cent. The remaining €30.7 billion will be included in the 2010 measure of the deficit, which we estimate would otherwise be 11½ per cent of GDP, a slight improvement on 2009.

At the time of writing there are no details of the likely composition of the forthcoming budget. The government is committed to producing a detailed four-year budgetary plan in early November. It seems likely, however, that the original plan for a package of €3 billion in cuts, including a reduction in capital expenditure of €1 billion, is likely to be closer to €4 billion, or even higher. In this context, we have implemented a stylised package of budgetary measures equivalent to €4 billion for 2011. These include an increase in taxation of €1.5 billion, a cut in current expenditure of €1 billion, a cut in welfare payments equivalent to €500 million and a cut in capital expenditure of €1 billion. By our estimates this package would reduce the General Government Deficit to 10 per cent of GDP in 2011.

Excluding the once-off costs of the bank bailout monies shows that there is a steady improvement in the underlying deficit.<sup>9</sup> The discrete impact of this huge cost to the Exchequer is best illustrated by looking at the gross and net debt figures. Figure 14 shows the ratio of gross government debt and net government debt (net of NPRF and exchequer cash balances) to GDP between 2000 and 2011. By our estimation, gross debt ratio will exceed 105 per cent by the end of 2011. Had there been no bank bailout costs, this ratio would be 83 per cent.

**Figure 14: Gross Government Debt and Net Government Debt as a Percentage of GDP**



<sup>9</sup> The underlying deficit does include the interest costs of the additional borrowing implied by the bank bailout monies. These interest costs are accrued to the deficit from the moment of issue of the promissory note. We have made a technical assumption that the interest rate paid on these notes will be 5 per cent.

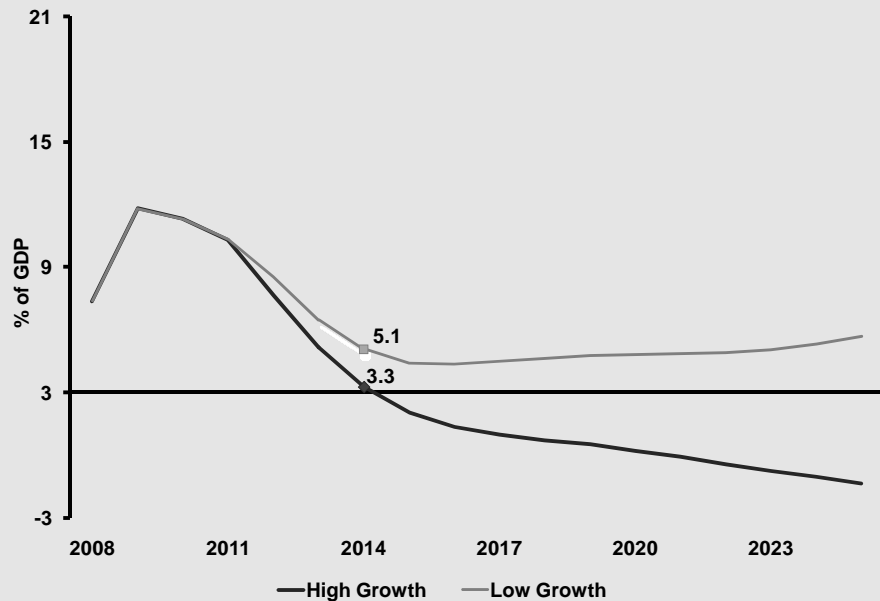
The costs of the bank bailout monies are very large. Excluding them, the underlying figures show that there has been some improvement in the fiscal balance – from 12.1 per cent to an estimated 11½ per cent of GDP – even within the context of a very deep recession. However, these costs do add to the underlying fiscal deficit, in particular the interest bill on the bank bailout monies is likely to exceed €1.5 billion per annum. In Box 2 we look at the government’s plan to bring the fiscal deficit (which includes interest costs on bank bailout monies) below 3 per cent of GDP by 2014. We use simulation results for both the *High Growth* and *Low Growth* scenarios from our publication *Recovery Scenarios for Ireland: An Update* of July this year. By our calculations, achieving a 3 per cent deficit target by 2014 under the *Low Growth* scenario could imply a package of cuts of the order of €15 billion. Such a package of cuts could cut 1 percentage point from the annual growth rate and could add over 60,000 to the level of unemployment. In that context a target 3 per cent deficit within 4 years would only be achievable at a very high cost in the real economy if the *Low Growth* scenario were to materialise. By contrast, if the *High Growth* scenario were to materialise, then a total package of €9 billion would be required to reach the target by 2014. This means that the growth path over the next four years is critical in determining the credibility of the multi-annual budgetary framework plan.

## **Box 2: Simple Extrapolations from Recovery Scenarios Analysis**

In this box we revisit some recent work published in July 2010, exploring recovery scenarios for the Irish economy. *Recovery Scenarios for Ireland: an Update* (RS2) was based on forecast numbers from the Spring 2010 *Commentary* for 2010 and 2011, an estimate of the total bank bailout cost of €25 billion, and a cumulative package of cuts of €7.5 billion over the period 2011-2014. This package of cuts was based on *Stability Programme Update* December 2009, published by the Department of Finance in the *Budget 2010* document. Based on these numbers, the medium term growth path of the economy was explored under two scenarios. Under the *High Growth* scenario the economy recovers fully in 2012 and the labour market moves back towards full employment. Under the *Low Growth* scenario, while there is significant growth, it is not sufficient to return the economy to full employment.

The central importance of growth in restoring stability to the public finances emerges from this analysis. As discussed at some length in the paper, the appropriate target for fiscal policy is the structural deficit. This excludes the once-off costs of the bank bailout monies but does include the interest costs of that borrowing. Figure 2A shows the RS2 estimates of this deficit. Excluding once-off items, the deficit in 2014 under the high growth scenario is estimated to be 3¼, for the low growth it is 5. More importantly, the path of the low growth deficit is not sustainable.

**Figure 2A: Deficit/GDP**



In *RS2*, the fiscal cost of the bank bailout (at that time estimated at €25 billion) identified three separate costs:

- 1) Interest cost of the bank bailout – estimated at €1.25 billion per annum.
- 2) The increase in the risk premium.
- 3) The cost of holding large cash deposits.

Given the additional €10 billion net cost of the bank bailout announced in September, the interest costs of this will add approximately  $\frac{1}{2}$  percentage point to the deficit in 2014.<sup>10</sup> A reasonable estimate would, therefore, suggest that the deficit under the high growth scenario is in the range  $3\frac{1}{2}$ -4 and under the low growth scenario is in the range  $5\frac{1}{2}$ -6. This means that to achieve a deficit of 3 per cent of GDP by 2014, the deficit needs to be cut by an additional one percentage point under the High Growth scenario and an additional 3 percentage points under the Low Growth scenario.

In order to estimate the likely scale of additional cuts needed to achieve these reductions, we can look at the analysis in *RS2*. In the 2011-2014 period, an austerity package of €7.4 billion reduced the structural deficit by  $2\frac{1}{2}$  per cent of GDP. A very crude rule of thumb would, therefore, suggest that a reduction of the structural deficit by 1 percentage point, requires a €2.5 to €3 billion fiscal adjustment package (Table 2A).

<sup>10</sup> In *RS2* the roll-out of the €25 billion bank bailout payment was treated as follows. €4 billion paid to Anglo-Irish Bank in 2009, €11 billion of promissory notes issued in 2010, with a remaining €8 billion promissory notes issued in equal instalments over a subsequent ten year period and interest payments on these promissory notes contributing a further €2 billion. Following the recent announcement by the Minister for Finance in September, we now assume that €30.7 billion in promissory notes will be issued before the end of 2010. This effectively adds  $\frac{1}{2}$  per cent to the structural deficit by 2014 relative to *RS2*.

**Table 2A: Impact of Austerity Package on the Deficit from RS2**

	Package of Cuts	Reduction in the Deficit	
		High Growth	Low Growth
2011-2014	€7.4 billion	2½	2½

RS2 also provides an estimate of the effect of such an austerity programme on growth. Specifically, Box A in RS2 compares the High Growth scenario with the World Recovery scenario published in May 2009. The key difference between the two scenarios relates to the €7.4 billion package of fiscal austerity measures included in the High Growth scenario. The impact of this package over the medium term (2011-2015) is to knock 1 percentage point off the annual growth rate, with income per head 5 per cent lower in 2015 and total employment 63,000 lower.

While these are very simple linear extrapolations they do give us a simple rule of thumb in guesstimating how the economy could reach a 3 per cent structural deficit target by 2014. The results are shown in Table 2B below. Under the High Growth scenario, an additional €1.5 to €3 billion in cuts would be needed, this in turn would reduce annual average growth by between ¼ and ½ per cent per annum.

Under the Low Growth scenario, an additional €7.5 billion in cuts would be needed, this in turn would reduce annual average growth to 2 ¼ per cent per annum and could add 60,000 to the level of unemployment. This level of growth would not be sufficient to clear the labour market. With stagnant or even rising unemployment, the linear relationship between cuts and the deficit assumed here could break down. There is a danger that a growth rate close to 2 per cent, following on a prolonged recession, could send the economy into a period of prolonged deflation.

**Table 2B: Deficit as Percentage of GDP**

	Cumulative 2011-2014 Fiscal Package	High Growth		Low Growth	
		2011-2015 Annual % Growth GDP	Deficit in 2014	2011-2015 Annual % Growth GDP	Deficit in 2014
RS2	€7.4bn	4½	3½ - 4	3¼	5½ - 6
Additional €1.5 - €3bn	€9 - €10.5bn	4 - 4¼	2½ - 3		
Additional €7.5bn	€15bn			2¼	2½ - 3

The target of a 3 per cent deficit by 2014 is critically dependent on a strong recovery in the world economy, a healthy and functioning Irish banking system, no further surprises and the labour market clearing to an unemployment rate of 5 per cent by 2015. If these conditions were met



then the “high growth” scenario would be more likely to occur and the target could be met without substantial dislocation. However, if these conditions were not to materialise, so that the economy pursues the “low growth” scenario, then the additional cuts necessary to achieve the 3 per cent deficit target could tip the growth path of the economy into a deflationary spiral involving significant costs that might be avoided through a limited extension of the time scale for the adjustment.

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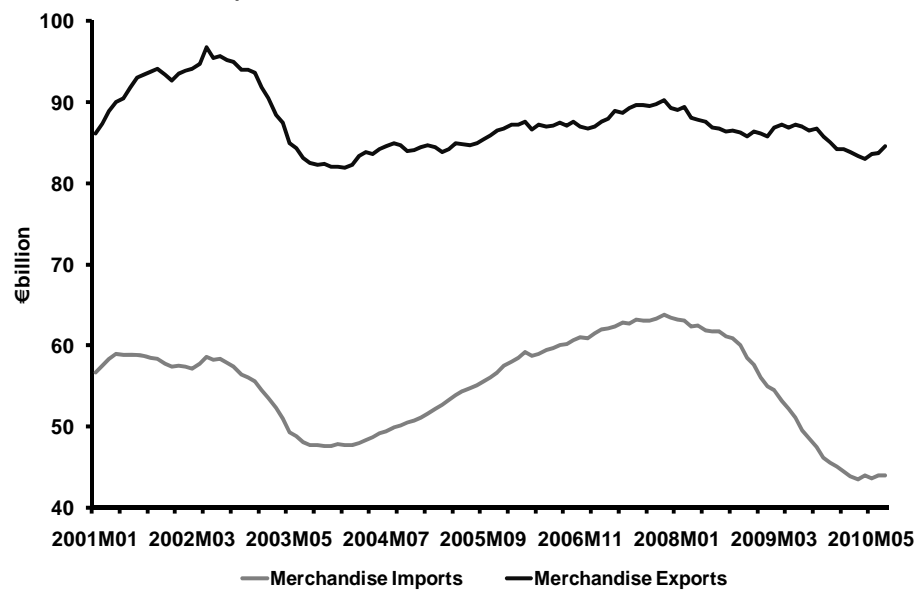
## Exports

In the latest *Quarterly National Accounts (QNA)* for 2010 Q2, the estimates suggest that exports continued to perform well in the second quarter. In the first quarter of 2010, the volume of exports grew by a very strong 7.5 per cent, in the second quarter the growth rate is estimated at 1.6 per cent. Against a background of falling volumes in 2009, these quarterly figures suggest that even with no further growth in the second half of the year, volume growth for the year as a whole would be 7.6 per cent. In terms of value, following a significant decline in export prices in 2009, more recent months have seen a resumption of price increases in the export sector, most notably in relation to merchandise exports.

These latest *QNA* figures confirm that the export sector has emerged from recession and returned to growth. The total value of exports of goods and services in the first six months of 2010 was higher than in any previous six month period. In relation to the performance of goods and services exports, it is the performance of exports from the services sector that underlies this growth. Monthly data from the *External Trade CSO* publication show considerable volatility in relation to the performance of exports. In June the monthly change in volume exports was -4.4 per cent while the value change was -3.7 per cent. Preliminary figures for July estimate the growth in the value of merchandise exports of 8.1 per cent. (These are all seasonally adjusted figures.) Because of the volatility in the monthly numbers, it is helpful to look at the data on an annualised basis. Figure 15 shows the annualised total value of merchandise exports and imports. These data indicate that there has been an increase in total merchandise exports beginning in the second quarter of 2010. A very strong performance from the pharmaceutical sector, which alone accounts for more than one-quarter of all merchandise exports, and to a lesser extent from the food sector, has helped to offset a very poor performance in the computer sector whose share of total exports has fallen from over 16 per cent in 2007 to 6 per cent in 2010.

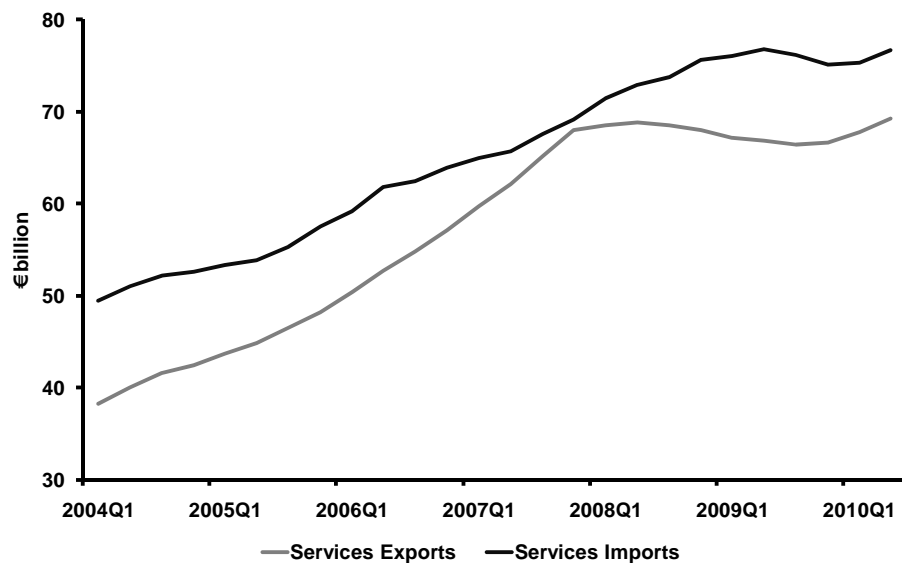
In relation to services exports, Figure 15 plots the annualised total value of services imports and exports. Between the end of 2007 and 2009 the value of services exports fell, leading to a significant widening of the services trade balance. This has begun to narrow in more recent quarters with a resumption in exports growth. For the year ended 2010 Q2, the value of services exports grew by 3.6 per cent. This strong performance masks significant variation, with tourism and travel shrinking by almost 22 per cent, and financial services by almost 4 per cent. This was more than offset by continued strong growth in business services, computer services and royalties and licences.

**Figure 15: External Trade Statistics 2001M01-2010M07 (Annualised, €billion)**



Source: Quarterly National Accounts, CSO.

**Figure 16: Total Services Exports and Imports (Annualised, €billion)**



Source: Balance of Payments Statistics, CSO.

Given the strength of the recent export performance we have revised upwards our figures for exports growth in total exports in 2010 and 2011. We now estimate volume growth in total exports in 2010 to be 7½ per cent, driven by strong growth in both merchandise exports – of 7½ per cent – and in services exports other than tourism. Since the most recent data suggest that exports of tourism continue to perform poorly, we estimate a small decline of ½ per cent in 2010 followed by a relatively strong recovery in 2011 of close to 6 per cent. We forecast that exports will continue to grow strongly in 2011, at 5½ per cent in volume terms. In relation to prices, much will depend on what will happen in foreign exchange markets over the forecast period. The recent strengthening of the euro, if it persists, will lead to an improvement in the terms of trade but

**Table 6: Exports of Goods and Services**

	2008	% Change in 2009		2009	% Change in 2010		2010	% Change in 2011		2011
	€bn	Volume	Value	€bn	Volume	Value	€bn	Volume	Value	€bn
<b>Merchandise</b>	81	-5.2	-4.9	77	7½	7½	83	5 ½	6	88
Tourism	4	-16.5	-18.2	4	- ½	-1	3	5 ¾	8	4
Other Services	64	-1.9	-0.8	63	8	8	68	5 ½	5½	72
<b>Exports of Goods and Services</b>	149	-4.1	-3.6	144	7½	7½	154	5 ½	5¾	163
FISIM Adjustment	1			1			1			1
<b>Adjusted Exports</b>	150	-4.1	-3.6	145	7½	7½	156	5 ½	5¾	165

at the cost of a loss of price competitiveness. For 2010 we expect that the growth in export prices will marginally exceed import prices, leading to a terms of trade gain of 0.5 per cent. We have assumed that in 2011 there will be a reversal of this terms of trade gain but this is highly dependent on the path exchange rates take in the coming months.

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## Imports

The total value of imports of goods and services fell by almost 15 per cent from their peak in the last quarter of 2007 to their trough in the last quarter of 2009. In particular, there has been a dramatic decline in merchandise imports as can be seen in Figure 16 above. The volume of merchandise imports fell by over 30 per cent between 2007 and 2009. Imports of non-tourism services, by contrast, recorded an increase over this period. In 2008 the value of non-tourism services imports grew by 9.2 per cent, before stagnating at 0.3 per cent in 2009. Imports of tourism services have fallen dramatically, by almost 11 per cent in 2009. This reflects the very strong contraction in personal consumption spending of 11 per cent in value terms.

Since the beginning of 2010, estimates from the *QNA* suggest that total imports have begun to grow again, both in value and volume terms. For the year ended 2010 Q2, the volume growth of imports of goods and services was -3.9 per cent, and the implied carryover growth rate was 3.7 per cent. We now estimate that volume imports of goods and services will grow by 3½ per cent in 2010. This represents a significant upward revision relative to the Summer *Commentary* where we expected stagnation in imports. This upward revision is driven by our higher estimate of exports in 2010. Irish exports tend to be highly import intensive, particularly in the services sector.

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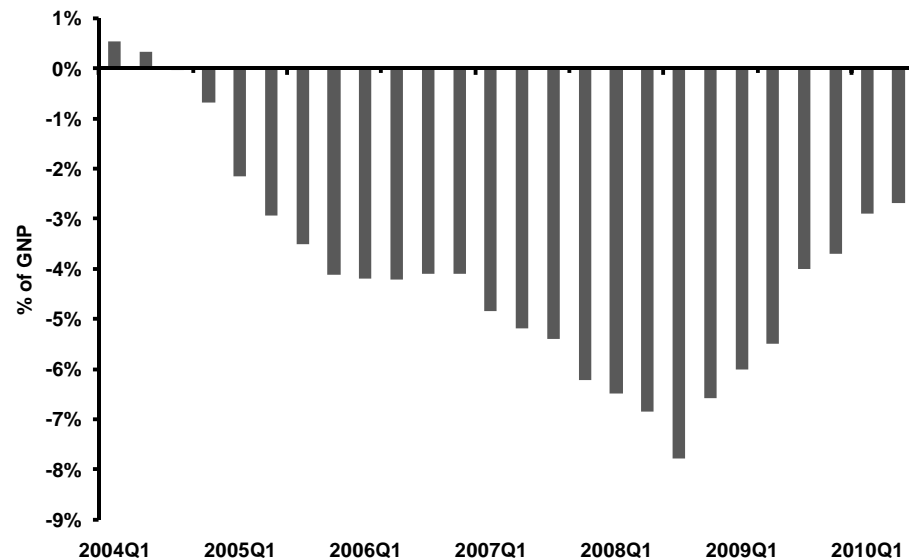
## Balance of Payments

The current account of the balance of payments began to shrink rapidly in the middle of 2008 (see Figure 17). From a peak of -7.8 per cent of GDP in 2008 Q3, by 2010 Q2 it is estimated to have shrunk rapidly to -2.7 per cent of GDP. This has been driven by the very rapid widening in the trade balance on goods and services. In particular, the merchandise trade balance increased by over €12 billion as imports of goods shrank rapidly. Offsetting this, the sharp decline in services exports discussed earlier resulted in a widening of the services trade deficit in both 2008 and 2009. Based on our forecasts for exports and imports, we expect the merchandise trade balance to increase further and we also expect the negative services balance to begin to close. These projections would result in rapid growth in the overall trade balance and would see it move from 18.3 per cent of GNP in 2009 to 24½ per cent in 2010 and almost 26¾ per cent in 2011.

**Table 7: Imports of Goods and Services**

	2008	% Change in 2009		2009	% Change in 2010		2010	% Change in 2011		2011
	₪bn	Volume	Value	₪bn	Volume	Value	₪bn	Volume	Value	₪bn
<b>Merchandise</b>	57	-18.4	-22.0	45	3	2 ½	46	3	4	48
Tourism	7	-10.3	-10.8	6	-2½	-3	6	1	2	6
Other Services	69	-2.6	0.3	69	4½	4	72	4½	5	75
<b>Imports of Goods and Services</b>	133	-9.7	-9.9	120	3½	3	123	3¾	4½	129
FISIM Adjustment	1			1			1			1
<b>Adjusted Imports</b>	134	-9.7	-10.1	120	3½	3	124	3 ¾	4½	130

**Figure 17: Current Account of Balance of Payments as Percentage of GNP, Annualised Data**



Source: Balance of Payments Statistics, CSO.

Offsetting this increase in the trade balance, is a widening of net factor income flows abroad. Having narrowed in 2008, these net outflows widened again in 2009. Looking at the detailed flows in the Balance of Payments, these suggest a very significant decline in both inflows and outflows of portfolio and other investment income. In 2009 total inflows of portfolio and other investment income fell by €28 billion while total outflows fell by €27 billion. In relation to outflows, there was a €4 billion increase in distributed profits outflows and reinvested earnings. Our projections for 2010 and 2011 suggest a further widening of net factor outflows. However, overall we expect the current account deficit to shrink to 0.1 per cent of GNP in 2010 and for 2011 we are forecasting a surplus of 1¼ per cent of GNP. Changes in the flow of funds between sectors of the Irish economy which match these developments in the balance of payments are discussed in the *Monetary* section.

**Table 8: Balance of Payments\***

	2008 €bn	Change %	2009 €bn	Change %	2010 €bn	Change %	2011 €bn
Merchandise Trade Balance	23.8		32.4		37.0		40.2
Service Trade Balance	-7.7		-8.4		-6.0		-5.6
<b>Trade Balance in Goods and Services on BoP basis</b>	16.1		24.0		31.1		34.5
<b>% of GNP</b>	10.4		18.3		24 ½		26 ¾
Total Debit Flows	109.2	-24.6	82.4	-8 ¾	75.2	-3	72.9
Total Credit Flows	84.0	-35.2	54.5	-17 ½	44.9	-9	40.9
<b>Net Factor Flows</b>	-25.2	10.9	-27.9	8 ¾	-30.2	6	-32.0
<b>Net Current Transfers</b>	-1.2		-0.9		-0.9		-0.9
<b>Balance on Current Account</b>	-10.2		-4.9		-0.1		1.6
Capital Transfers	0.0		-1.3		0.1		0.1
<b>Effective Current Balance</b>	-10.1		-6.1		0.0		1.7
<b>% of GNP</b>	-6.5		-4.7		0		1 ¼

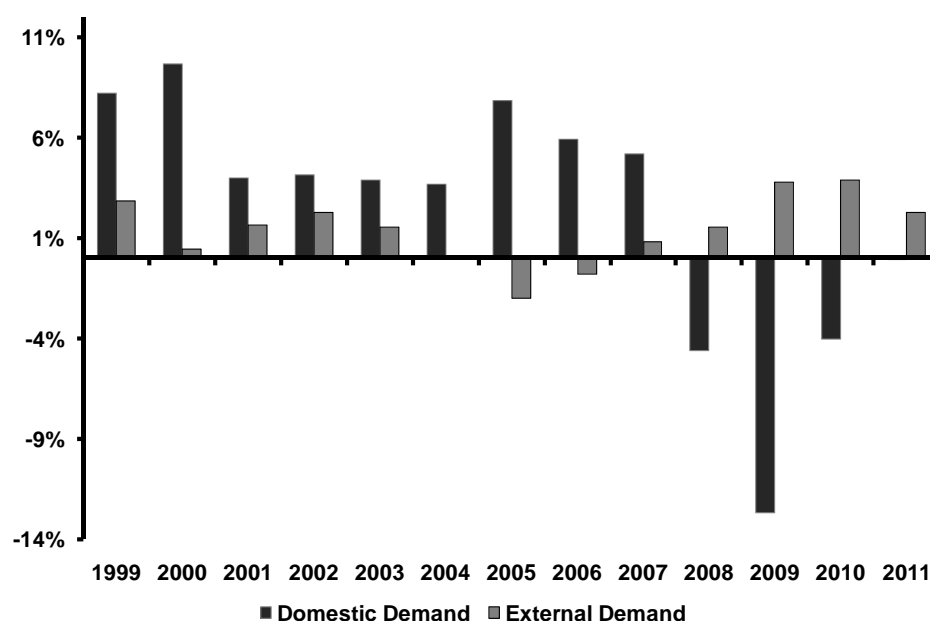
\*This table includes adjustments to Balance of Payments basis.

## Measures of Performance

Table 9 provides a range of indicators that seek to measure the performance of the Irish economy in the recent past, as well as forecasts of how they are expected to change up to the end of 2011. GNP is expected to decline further this year before returning to growth in 2011. GNP growth is forecast to be  $-1\frac{1}{2}$  per cent in 2010 and  $+2$  per cent in 2011. Due to the continuing natural increase in population, it is estimated that the fall in GNP per person in 2010 will be steeper than the fall in GNP. However, outward migration is expected to outweigh the natural increase in population in 2011, so that GNP per person will grow faster than GNP. See the *Employment* section below.

Figure 18 shows the contribution of domestic and external demand to the overall rate of GDP growth.<sup>11</sup> The data for 2008 and 2009, in addition to our estimates for 2010, suggest that the contractions in GDP in each of these three years are entirely driven by the contraction in domestic demand, with the external sector making a positive contribution to growth. In 2009, external demand contributed almost 4 per cent to overall GDP growth, its largest contribution since 1999. Our forecasts imply a similar contribution by the external sector to GDP growth in 2010.

**Figure 18: Contributions to Growth, Per Cent**



<sup>11</sup> The growth rates in external and domestic demand are weighted by their respective share in GDP. Therefore, these two growth rates sum to the overall growth in GDP.

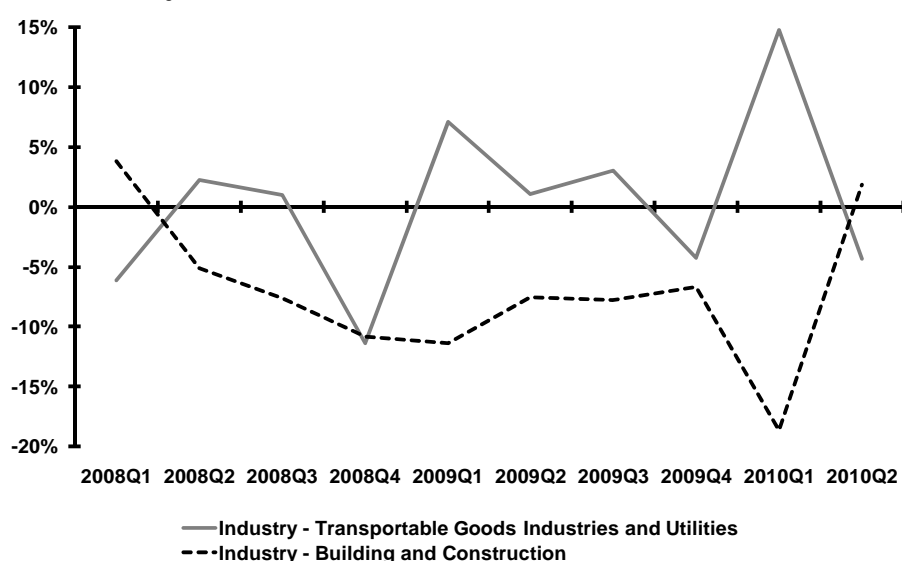
**Table 9: Performance Indicators**

Performance Indicators	2005	2006	2007	2008	2009	2010(f)	2011(f)
GNP, in constant prices	6.0	6.5	4.5	-3.5	-10.7	-1 ½	2
GNP adj for Terms of Trade	5.2	5.5	3.1	-5.9	-9.8	-¾	1 ½
GNDI, constant prices	5.1	4.9	2.8	-6.0	-9.7	-¾	1 ½
National Resources	5.0	4.9	2.6	-6.0	-10.6	¼	1 ½
GNP per capita (constant prices)	3.7	4.0	1.9	-5.3	-11.4	-1 ¾	2 ¼
Consumption per capita (constant prices)	4.6	4.2	3.8	-3.3	-7.8	-¾	1 ¼
Investment in Housing/GNP	14.9	14.7	13.2	9.8	5.6	3 ¼	3
Investment/GNP	31.4	31.2	30.8	25.7	18.8	13 ¾	13 ¼
Domestic Demand	9.0	6.4	5.5	-5.2	-13.9	-4 ½	-¼
Labour share of GNP	47.5	46.8	48.0	51.3	55.4	53 ¾	52

## Sectoral Output

The latest *QNA* (Q2 2010) showed a decline in industrial output (excluding building and construction) in the latest quarter, based on the seasonally adjusted series. As can be seen from Figure 19, this decline in output came after a particularly strong performance in the first quarter. These rates of output growth mirror the rates of export growth between Q1 and Q2. As discussed above in the section on *Exports*, the rate of growth in exports declined markedly between Q1 and Q2, although it remained positive in Q2. Somewhat surprisingly, Figure 19 also shows an increase in building and construction output in Q2. Of course, given the low base that now applies in this sector, even modest increases in activity will register in percentage terms. Between Q1 and Q2, the increase in output in the sector was €29 million.

**Figure 19: Quarter-on-Quarter Growth Rates in Industry, Seasonally Adjusted**



Source: Quarterly National Accounts, CSO.

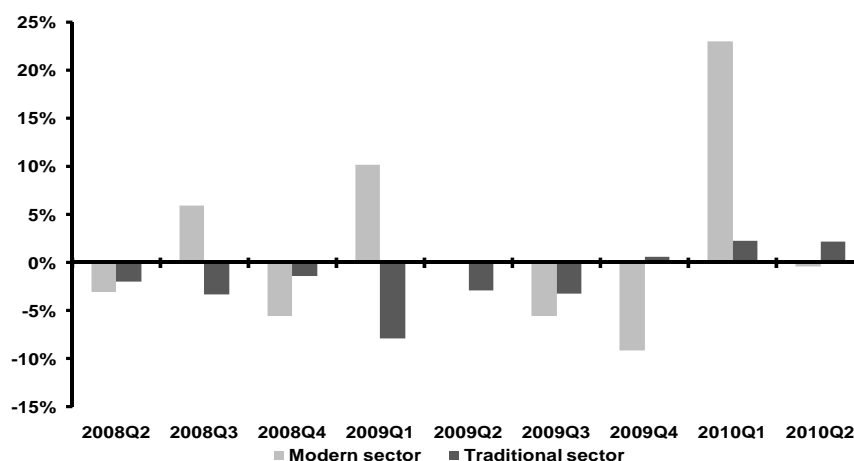


**Table 10: GDP by Sector**

	2008	% Change		2009	% Change		2010	% Change		2011
	€bn	Volume	Value	€bn	Volume	Value	€bn	Volume	Value	€bn
<b>Agriculture</b>	3.7	-3.6	-19.5	3.0	5	10	3.3	2	5	3.4
<b>Industry:</b>	49.7	-7.8	-8.4	45.6	-0	-1 ½	44.8	3 ¼	2 ¾	46.1
Other Industry	37.4	-0.1	0.2	37.5	7	6	39.7	5	4 ½	41.5
Building & Construction	12.3	-31.4	-34.3	8.1	-31 ½	-37	5.1	-8	-10 ¾	4.5
<b>Services:</b>	106.1	-3.8	-9.5	96.1	- ¼	-1 ½	94.5	1 ¾	1 ¼	95.6
Public Administration & Defence	6.4	-0.5	-1.2	6.4	-3	-7 ¼	5.9	-2	-3	5.7
Distribution, Transport and Communications	24.1	-9.3	-9.7	21.8	0	-2	21.3	2	3	21.9
Other Services (including rent)	75.6	-2.3	-10.1	67.9	- ¼	- ¾	67.3	2	1	68.0
<b>GDP at Factor Cost</b>	159.5	-5.0	-9.4	144.6	- ¼	-1 ¼	142.6	2 ¼	1 ¾	145.1

The large downturn in the rate of growth in industrial activity between Q1 and Q2 2010 is also captured in Figure 20 where we show recent quarterly growth rates in the Index of Industrial Production for the modern and traditional sectors. The modern sector showed a particularly large jump in output in Q1 but this turned into a small minus in Q2. For the traditional sector, the impression that emerges from the figure is of a steady pace of recovery. Growth in this sector has now been positive in the last three quarters.<sup>12</sup>

**Figure 20: Quarter-On-Quarter Sectoral Growth Rates in Industrial Production Index, Seasonally Adjusted**

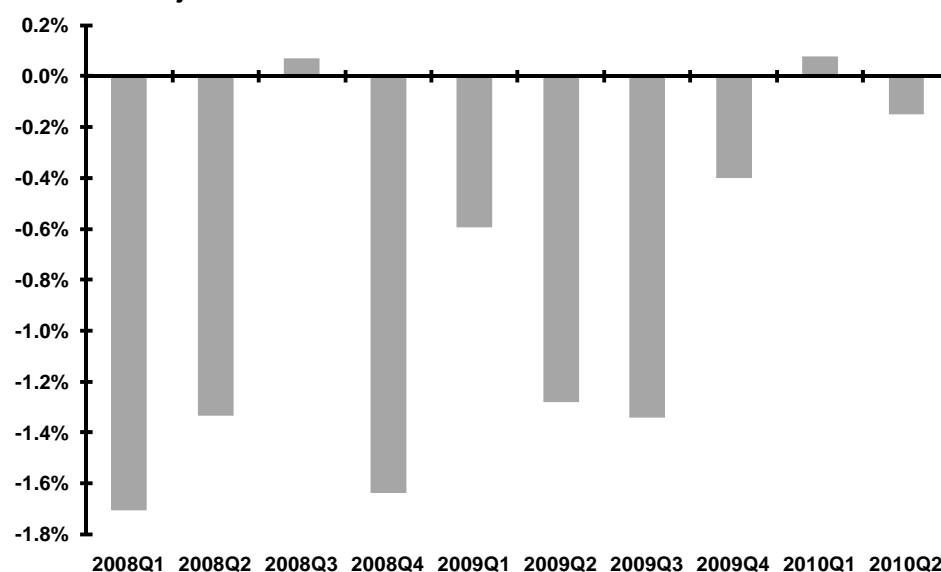


Source: Industrial Production Index, CSO.

Turning to services, in Figure 21, we plot the quarter on quarter growth rates going back to Q1 2008. The first key point to be made is that the volatility in output is very much lower than in the case of industry. The largest quarter-on-quarter falls have been less than 2 per cent but the series barely rises above zero at any point. For the most recent quarter, output fell although by a negligible amount. Across the three sub-categories of Distribution, Transport and Communications, Public Administration and Defence and Other, the changes in output between Q1 and Q2 were all close to zero.

<sup>12</sup> We should note that in July and August, the index of industrial production has registered strong gains relative to July and August of 2009 (13.4 per cent and 10.4 per cent respectively). This provides a positive sign for the likely outcome for Q3.

**Figure 21: Quarter-on-Quarter Growth Rates in Services, Seasonally Adjusted**



Source: Quarterly National Accounts, CSO.

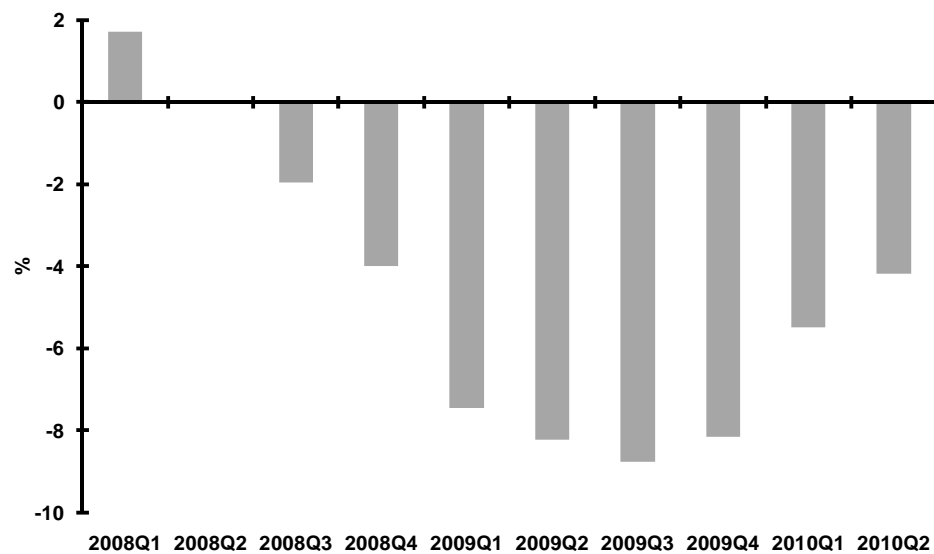
Turning to our forecasts, we expect industrial output to grow by 7 per cent in 2010 and by 5 per cent in 2011. For building and construction, we expect a fall in output of 31½ per cent in 2010, moderating to 8 per cent in 2011. For services, we expect a volume decline of ¼ per cent this year and an increase of 1¾ per cent next year.

## Employment

According to the latest *Quarterly National Household Survey (QNHS Q2)*, there were 1.863 million people employed in the second quarter (seasonally adjusted). As employment peaked at 2.138 million in the fourth quarter of 2007, the decline in the number employed since that peak is now 275,600 or 13 per cent. The number in the labour force was 2.148 million in Q2 2010. The peak was around Q4 2007/Q1 2008, when the labour force reached 2.247 million. Hence, the decline in the labour force from the peak to the most recent reading is 99,600, or 4.4 per cent. The number unemployed now stands at 284,500, compared with 108,200 in Q4 2007. This means that the increase in the number unemployed over this period was 176,000 or 163 per cent. The rate of unemployment in Q2 2010 was 13.6 per cent; according to the Live Register, the rate of unemployment in September was 13.7 per cent.

Clearly, these numbers are stark but it is at least possible to say that the pace of job loss appears to be easing. As shown in Figure 22, the fastest pace of job loss was experienced in Q3 of 2009 when the year-on-year rate of job loss reached 8.8 per cent. The pace has been easing since then, with the most recent figures showing a rate of job loss of 4.2 per cent.

**Figure 22: Year-on-Year Percentage Change in Employment, Q1 2008 to Q2 2010**



Source: Quarterly National Household Survey, CSO.

We noted above that the labour force has fallen by almost 100,000 since the end of 2007. Some of this is explained by outward migration and also by falling participation. As with other variables, the participation rate peaked in Q4 2007 and has been declining since. At the peak, it was 64.1 per cent but it has fallen continuously since then and stood at 61.1 per cent in Q2 2010.

On out-migration, the *Population and Migration Estimates* published in September showed that there was a net outflow of 34,500 in the year ending April 2010. This was well below our forecast of 70,000. However, another source of CSO data on migration, (the *QNHS*), suggests that the figure of 34,500 may be an under-estimate of the actual outflow in the year ending April 2010 and that our forecast of 70,000 is likely to have been more accurate than suggested by the *Population and Migration Estimates*. According to the *Population and Migration Estimates*, the net outflow of 34,500 was made up of a net outflow of 14,400 Irish nationals and 20,100 non-nationals. However, if we compare the estimates for the number of non-nationals living in Ireland in Q2 2009 and Q2 2010,<sup>13</sup> we see that the population is estimated to have fallen by 52,800. It should be noted that the figures in the *Population and Migration Estimates* refer to the full population, whereas the *QNHS* counts people over the age of 15 years. It is also the case that the time period covered differs slightly. Nevertheless, the discrepancy between the two sources (20,100 versus 52,800) is certainly suggestive of a higher net outflow relative to the level reported in the *Population and Migration Estimates*.

In our last *Commentary*, we drew attention to two dimensions of the current unemployment crisis, namely, the huge rate of youth unemployment and the increase in long-term unemployment. The most

<sup>13</sup> QNHS Table A1

recent figures show that the rate of unemployment for those aged 15-19 years is now 40.6 per cent; for those aged 20-24 years, the rate is 25.8 per cent. The rate of long-term unemployment is now 5.9 per cent, up from 5.3 per cent in Q1 2010. This rising level of long-term unemployment is of particular concern. As the probability of returning to work diminishes with the length of time out of work, this rapid rise points to a potential difficulty in reducing the rate, even in a context of increasing employment.

In Box 3 below on unemployment by education level, we track the trend in the numbers and proportions unemployed between 1988 and 2009. The recent *QNHS* release allows us to look at this for 2010, although based on the ILO definition of unemployment. In Table 11, we reproduce these figures for Q2 2010 and the picture that emerges in the Box is seen here also. Less than a third of those unemployed are in the lowest two educational categories, that is, 88,400 or 30 per cent. However, the rates of unemployment are higher in the lower educational groups.

While it might seem intuitively sensible to say, based on these figures, that active labour market policy should focus on the biggest number of unemployed people, this may not be correct in reality. We know from many studies of unemployment that people with higher levels of education are more likely to return to work following a spell of unemployment unaided, relative to less educated people. There is no evidence to suggest that this pattern no longer applies in Ireland. As a result, the case can still be made that scarce resources, when spent on labour market training and employment programmes, should generally be directed towards those who need them most, i.e., those with greatest educational disadvantage but with the capacity to benefit from education or training programmes. For better educated groups, interventions may still be required but different sorts of interventions, such as internships, are likely to be needed.

**Table 11: Numbers Unemployed and Rates of Unemployment by Education Group, Q2 2010**

Education Level	Number Unemployed	Unemployment Rate
Primary or below	26.5	20.5
Lower secondary	61.9	22.9
Higher secondary	86.4	15.4
Post leaving cert	46.1	17.7
Third level non-honours degree	29.9	9.0
Third level honours degree or above	33.0	6.7
Other	9.0	14.5
Total persons aged 15-64 years	292.9	13.9

Turning to our forecasts, we expect the numbers employed to average 1.86 million this year. This would represent a fall of 68,000 relative to the annual average in 2009, or 3.5 per cent. We expect a further fall in the number employed in 2011, with the number now forecast at 1.85 million. On unemployment, we expect the rate to average 13¼ per cent in 2010 and

13½ per cent in 2011. We expect net outward migration to be 60,000 in the year ending April 2011 (Table 12).

**Table 12: Employment and Unemployment**

	Annual Averages 000s			
	2008	2009	2010	2011
Agriculture	115	96	85	88
Industry	520	411	367	360
Services	1,465	1,422	1,408	1,401
Total at Work	2,100	1,929	1,860	1,850
Unemployed	141	259	286	289
Labour Force	2,241	2,187	2,146	2,139
Unemployment Rate %	6.3	11.8	13 ¼	13 ½
Net Migration	38.5	-7.8	-34.5	-60.0
of which: Inward Migration	83.8	57.3	30.8	15.0
Change in Participation Rate*	-0.3	-1.2	-1	½

*Note:* Participation rate measured as share of population aged 15-64 years; based on Q2 figures as are migration figures.

### Box 3: Unemployment by Education (LFS/QNHS Data)

There has been a significant change in the educational profile of the unemployed since the late 1980s. There had been a steady decline in numbers unemployed with primary and junior educational attainment (Table 3A), but the recent recession has led to a dramatic rise in the numbers unemployed with Leaving Certificate level education, particularly in 2009 (see Table 3A). There is also a significant difference in relation to education levels by gender. The proportion of the unemployed with higher levels of education (leaving and third level) in total unemployment is consistently higher for females (77 per cent in 2009). This could be the result of less educated women being more likely to describe themselves as being non-participants, as opposed to an underlying difference in the employment prospects of more educated men and women.

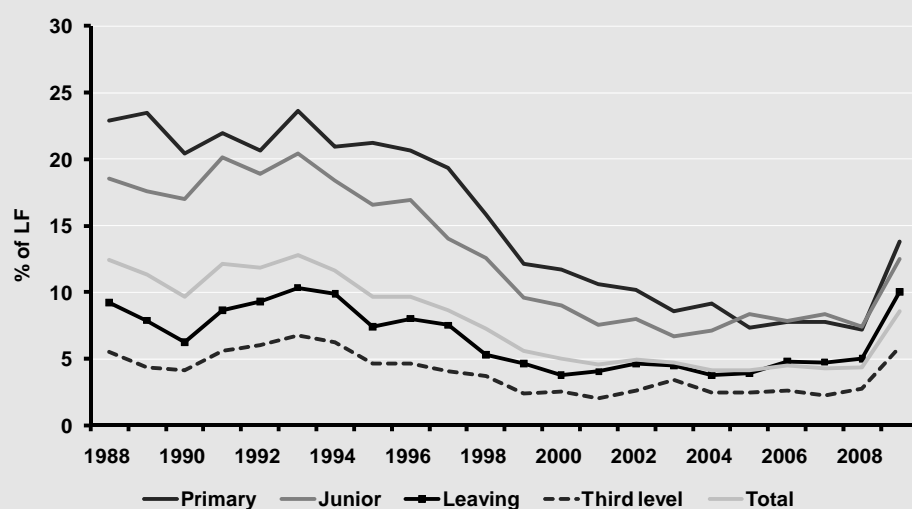
**Table 3A: Numbers Unemployed by Education Level**

	1988	1993	2001	2004	2007	2008	2009
<b>Total</b>							
Primary	99	80	39	33	29	27	45
Junior Certificate	67	79	22	29	31	39	68
Leaving Certificate	38	49	26	32	41	52	132
Third level	12	21	9	16	20	24	60
<b>Total</b>	217	229	97	111	121	143	305
<b>Female</b>							
Primary	13	12	8	5	5	4	7
Junior Certificate	16	19	7	7	9	7	11

Leaving Certificate	15	20	12	12	17	18	36
Third level	5	9	4	7	9	11	25
<b>Total</b>	<b>49</b>	<b>59</b>	<b>32</b>	<b>31</b>	<b>38</b>	<b>40</b>	<b>79</b>
<b>Male</b>							
Primary	86	69	32	28	24	23	38
Junior Certificate	52	60	15	22	22	32	57
Leaving Certificate	23	29	14	20	25	35	95
Third level	7	12	5	9	11	13	35
<b>Total</b>	<b>168</b>	<b>170</b>	<b>66</b>	<b>79</b>	<b>82</b>	<b>103</b>	<b>226</b>

Source: CSO Labour Force Survey data. All of these data are on a PES basis.

**Figure 3A: Unemployment Rates by Educational Level**



Source: LFS and QNHS, CSO.

Figure 3A shows unemployment rates within each educational category. The familiar pattern emerges; people with lower levels of education have a much higher probability of being unemployed than those with higher levels of education. In 2009, the unemployment rate of those with Junior Certificate education was over 22 per cent; for those with primary level education, the rate was over 26 per cent. These are similar to the unemployment rates seen in the late 1980s and early 1990s. However, the change in the educational composition of the work force means that while the unemployment *rates* are much higher for those with lower levels of education the actual *numbers* unemployed are now concentrated in those with higher levels of education.

As noted in the section on employment, care must be taken when distilling policy implications. State-funded labour market interventions should be aimed at those in greatest need of assistance and not necessarily at those who make up the greatest numbers of unemployed people.

## Incomes

In Table 13, we show the year-on-year changes in earnings, both hourly and weekly, and also changes in hours worked for Q1 2010. The first point to be made is that hourly earnings averaged across all sectors registered a decline. This is noteworthy because up to this point no such decline in overall earnings had shown up in the data, in spite of the very depressed conditions in the labour market. For example, in Q4 2009 hourly earnings were shown to have increased by 0.9 per cent across all sectors. Weekly earnings in Q4 2009 did register a decline (0.6 per cent) but this resulted from a fall in hours worked (1.5 per cent). In Table 13 we see that hours worked also fell in Q1 2010.

**Table 13: Year-on-Year Percentage Change in Earnings and Hours Worked, All Employees, 2010 Q1**

	Weekly Earnings	Hourly Earnings	Weekly Hours Worked
All NACE economic sectors	-3.8	-1.5	-2.2
Industry (B to E)	-0.8	0.5	-1.1
Mining and quarrying (B)	0.8	2.2	-1.3
Manufacturing (C)	-0.7	0.4	-1.1
Electricity, water supply and waste management (D,E)	-4.9	-1.3	-3.7
Construction (F)	-3.5	-2.6	-1.1
Wholesale and retail trade; repair of motor vehicles and motorcycles (G)	-3.1	-1.1	-2.0
Transportation and storage (H)	-7.3	-6.5	-0.8
Accommodation and food service activities (I)	-4.8	-1.4	-3.5
Information and communication (J)	-4.1	-2.0	-2.2
Financial, insurance and real estate activities (K,L)	1.0	1.5	-0.6
Professional, scientific and technical activities (M)	0.8	3.1	-2.1
Administrative and support service activities (N)	-1.5	0.0	-1.3
Public administration and defence; compulsory social security (O)	-6.3	-4.1	-2.2

Source: *Earnings, Hours and Employment Costs Survey (EHECS)*, CSO.

Looking across the sectors, it can be seen that falls in hourly wages are now broadly based. Seven of the thirteen sectors show wage falls. The biggest fall is in transport and storage, at 6.5 per cent, with the second largest fall being in public administration and defence, at 4.1 per cent. The biggest rise was experienced in professional, scientific and technical activities, where an hourly wage increase of 3.1 per cent was recorded.



Excluding bonuses, the rise in this sector was essentially the same (3 per cent) so the rise cannot be explained by bonuses. All sectors show declines in hours worked per week.

Another comparison of interest relates to movements in public sector and private sector earnings. In Q1 2010, public sector hourly earnings had fallen by 3.7 per cent year-on-year whereas private sector hourly earnings had fallen by 0.4 per cent. The estimates of public sector earnings do not take account of the pension levy introduced in Q2 2009. The fall in hours was greater in the private sector (2.5 per cent versus 1.9 per cent in the public sector). On balance, the fall in weekly earnings in the public sector (at 5.5 per cent) exceeded that in the private sector (2.8).

Turning to our forecasts, we expect wages to fall by 3 per cent in 2010 due to on-going weakness in the labour market as discussed in the *Employment* section above. When combined with our expectation of employment falls, this implies a fall in non-agricultural wages of 6 per cent. Personal disposable income is expected to fall by  $2\frac{3}{4}$  per cent. With consumption falling at a similar rate, this implies that the savings rate will remain over 10 per cent in 2010. It reached this level in 2009, having been 5.2 per cent in 2008 and 3.5 per cent in 2007. For 2011, we expect wages to fall again but at the more modest pace of 1 per cent. With employment expected to stabilise in 2011, the fall in non-agricultural wages will be modest relative to 2010, at  $1\frac{3}{4}$  per cent. Personal disposable income is expected to rise by  $2\frac{3}{4}$  per cent in 2011, driven largely by an increase in other non-agricultural income. With consumption expected to grow by 2 per cent, the savings rate is forecast to remain above 10 per cent again in 2011.

#### **Box 4: Homes Repossession Cases – Some Preliminary Findings**

By David Duffy

The economic downturn has contributed to severe difficulties for households. In the housing market this is evidenced by the rise in the number of mortgages reported to be in arrears and properties abandoned, surrendered or repossessed. Since September 2009 the Financial Regulator has published quarterly residential mortgage arrears and repossessions statistics. Despite the downturn in the housing market and the economy the growing number of mortgages in arrears has, to date, not translated into a substantial increase in repossessions. The latest data show that the total number of properties repossessed in the twelve month period to end-June was 387.<sup>14</sup> However, there is evidence of the difficulties being faced by households in the number of households voluntarily surrendering or abandoning their properties over the last nine months.

Towards the end of July this year the Master of the High Court announced that 600 new cases for repossession had come onto his list since June<sup>15</sup>. The lending institutions in these repossession cases that had

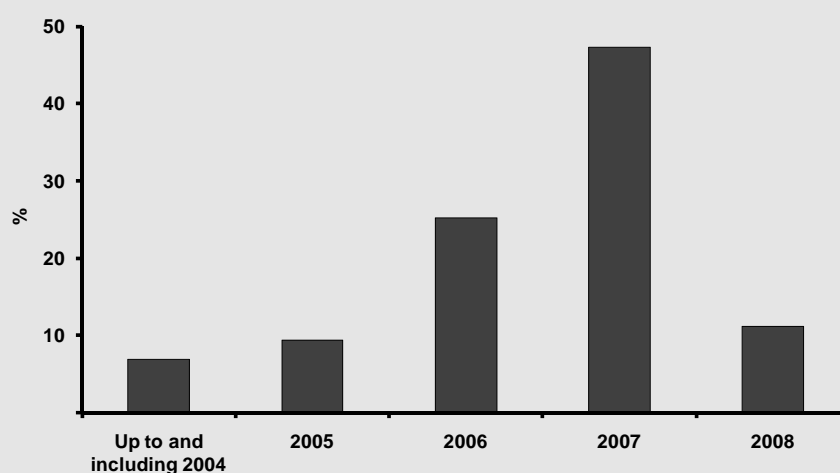
<sup>14</sup> Financial Regulator, “Residential Mortgage Arrears and Repossession Statistics”, Press Release September 1, 2010.

<sup>15</sup> “Court gets 600 cases to repossess homes”, *The Irish Times*, July 21, 2010.

come before the court were asked by the Master to provide information on the location of the property, whether or not it was the borrower's primary residence, the marital status of the borrower, the type of residence, the extent of the arrears, the size of the original mortgage and year of loan drawdown, as well as the type of lending institution. The anonymised raw data were given to the ESRI for analysis. This note outlines the main results. Around 540 cases (90 per cent) relate to mortgages and are not commercial loans. In the majority of cases repossession related to the family home (79 per cent), 2 per cent to properties that were unoccupied or abandoned, and 19 per cent to property that was not the borrower's residence. For some of the last group this includes land or sites. The following analysis is of those repossession cases that could be identified as relating to the borrower's residence.

Most of the repossession cases related to married couples or joint mortgages (63 per cent), with single borrowers accounting for nearly 29 per cent, while divorced, separated or widowed account for just over 8 per cent. Sub-prime lenders account for nearly 85 per cent of repossession cases<sup>16</sup>. Dublin accounts for 13 per cent of cases, followed by Tipperary (7.6 per cent), Galway and Meath (7.3 per cent each), Louth and Cork (6.1 per cent each) and Kildare, (5.9 per cent). The data also show that the majority of those facing repossession borrowed late in the housing boom – mortgages taken out in 2006 and 2007 account for over 72 per cent of cases.

**Figure 4A: Repossession Cases by Year of Drawdown**



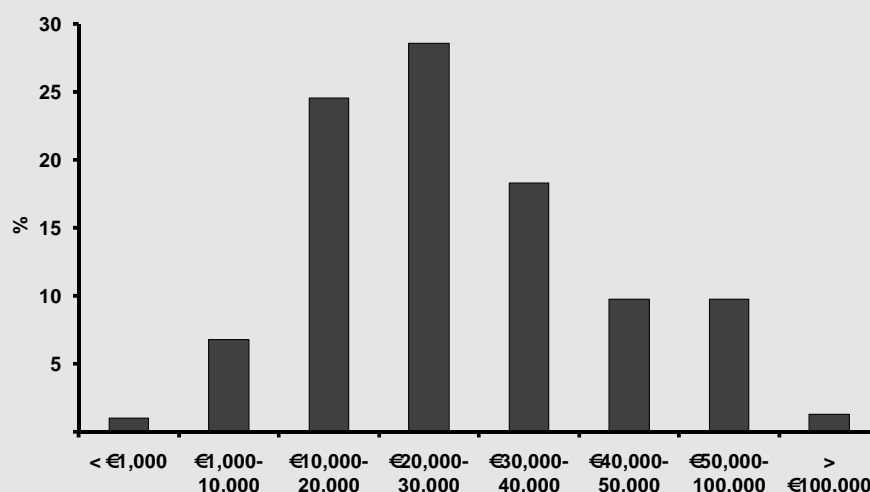
Source: Anonymised Data from the Master of the High Court and Own Calculations.

The data show that for repossession cases the average loan on a borrower's residence is nearly €236,000. Average arrears are nearly €30,000. The average ratio of arrears to original loan size is 13.2 per cent. The average loan size peaked for those mortgages drawdown in 2007 at

<sup>16</sup> Sub-prime lending is generally lending where a higher rate of interest than normal market rates is charged on the loan on the basis that the applicant borrower is perceived to be a greater credit risk.

€261,400 but average arrears are highest for mortgages drawdown in 2008, at over €35,000. The data show that there is quite a distribution in the amount of arrears. Figure 4B suggests that some borrowers face repossession based on relatively low arrears.

**Figure 4B: Repossession Cases, Distribution of Arrears**



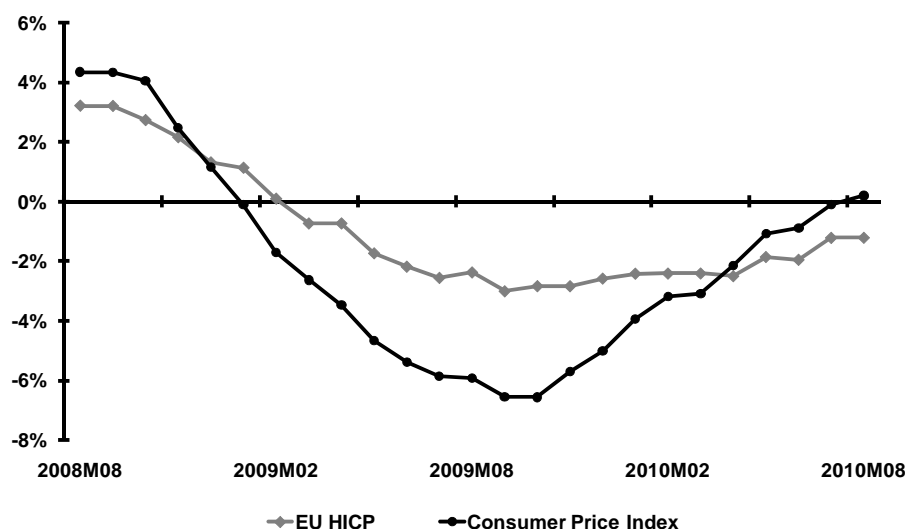
Source: Anonymised Data from the Master of the High Court and Own Calculations.

The data show that the majority of those who currently face repossession borrowed from subprime lenders. It is also noteworthy that most repossessions relate to married couples and the family home rather than to investment properties. Finally, most repossession cases related to borrowers who took out a mortgage late in the house price cycle.

## Consumer Prices

Following a period of rapid decline, consumer prices have been increasing modestly since the start of 2010. According to the latest figures from the CSO, the *Consumer Price Index (CPI)* rose 0.2 per cent in August 2010, compared to August 2009, as can be seen in Figure 23. This is the first year on year increase in consumer prices since December 2008.

**Figure 23: Price Indices – Year-On-Year Percentage Change**



Source: Consumer Price Index & Harmonised Index of Consumer Prices, CSO

**Table 14: Personal Disposable Income**

	2008	Change		2009	Change		2010	Change		2011
	₪bn	%	₪bn	₪bn	%	₪bn	₪bn	%	₪bn	₪bn
Agriculture, etc.	2.9	-24.4	-0.7	2.2	10	0.2	2.4	5	0.1	2.5
Non-Agricultural Wages	79.4	-8.5	-6.7	72.7	-6	-4.4	68.3	-1 ¾	-1.2	67.1
Other Non-Agricultural Income	16.6	-18.3	-3.0	13.6	7 ½	1.0	14.6	29 ¼	4.2	18.8
<b>Total Income Received</b>	98.9	-10.6	-10.5	88.4	-3 ½	-3.2	85.2	3 ¾	3.2	88.4
Current Transfers	24.6	8.8	2.2	26.7	1	0.3	27.0	- ¼	-0.1	26.9
<b>Gross Personal Income</b>	123.4	-6.7	-8.3	115.1	-2 ½	-2.9	112.2	2 ¾	3.1	115.3
Direct Personal Taxes	23.4	-8.0	-1.9	21.6	-1 ½	-0.3	21.2	3 ¼	0.7	21.9
<b>Personal Disposable Income</b>	100.0	-6.4	-6.4	93.6	-2 ¾	-2.6	91.0	2 ¾	2.4	93.4
Consumption	94.8	-11.1	-10.5	84.3	-2 ½	-2.1	82.2	2	1.7	83.9
<b>Personal Savings</b>	5.2			9.2			8.8			9.5
<b>Savings Ratio</b>	5.2			9.9			9 ¾			10 ¼
<b>Average Personal Tax Rate</b>	19.0			18.7			19			19

As discussed in previous editions of the *Commentary*, the mortgage interest component is a strong driver of variation in the CPI. Amidst aggressive cuts to ECB interest rates, mortgage interest rates fell 48.7 per cent from their height in October 2008 to August 2009. In the year since then, mortgage interest rates have increased by 28.6 per cent. This is a result of the increased borrowing costs facing Irish banks. The Harmonised Index of Consumer Prices (HICP) seeks to measure the price level excluding mortgage interest. By this measure, prices fell -1.2 per cent between August 2009 and August 2010 as seen in Figure 23.

Further upward pressure on consumer prices has come from the increasing cost of education, in particular from the rising cost of third level education. Overall, education costs increased 9.5 per cent in the year to August, whereas the price of tertiary education increased by 21 per cent. Other significant year-on-year price increases include the price of air transport, which increased  $18\frac{1}{4}$  per cent, and the price of liquid fuels, which increased by  $26\frac{3}{4}$  per cent.

These price increases are offset by further decreases in many other commodity groups. The ongoing weakness of sterling versus the euro, coupled with weak domestic demand, has meant that clothing and footwear prices have continued to fall over the past year, with prices 8.2 per cent lower than in August 2009. Food prices have fallen by 3.2 per cent year-on-year, although much of this decline occurred in late 2009 with prices remaining stagnant throughout 2010.

In the *General Assessment* of the Winter 2008 *Commentary*, the inherent dangers of negative price inflation were discussed. On-going price declines can create an expectation amongst consumers that prices will fall further in the future, which creates an incentive to postpone consumer spending. Under this scenario, debt burdens – for individuals, institutions, and the government – become more expensive in real terms due to an increase in the real interest rate. Lower prices and a greater real debt burden reduce demand in the economy, forcing additional price reductions, leading to a deflationary cycle. However, if the decline in the price level is not persistent, it can have the potentially positive effect of raising the value of real nominal incomes. Temporary negative inflation also improves competitiveness through reduced costs, which increases the return on investment in the economy. For this reason, whether or not the declining price level is persistent is of vital importance to the economy.

The CPI is estimated to fall by  $\frac{3}{4}$  per cent in 2010. This is a downward revision of our earlier forecasts, due to later than expected increases in the mortgage interest rate. The HICP is expected to fall by  $1\frac{1}{2}$  per cent this year, which represents a small upward revision of our previous estimate due to the moderation of the price declines for many of the non-mortgage interest rate commodity categories. Positive price inflation is expected to return next year, with the CPI forecast to increase by  $1\frac{3}{4}$  per cent and the HICP forecast to increase by  $\frac{1}{2}$  per cent.

## PRIVATE SECTOR CREDIT AND DEPOSITS

The annual rate of change in loans to households, which accounts for around 43 per cent of the overall stock of private sector credit outstanding, turned negative in October 2009 and that decline has persisted in recent months according to the latest statistics from the Central Bank (Table 15).<sup>17</sup> Underlying the fall in the overall stock of loans to households has been ongoing falls in lending for house purchase as well as lending for consumption and other purposes. Lending for house purchases declined by -0.7 per cent in August reflecting the ongoing weakness of activity in the property market. Lending for consumption purposes declined in March 2009 for the first time since the series began in January 2003. The annual rate of change stood at close to -14 per cent in July and August 2010. The level of credit outstanding to households peaked in mid-2008 at around €156 billion.

**Table 15: Private Sector Credit and Deposits**

		Credit to Households, €Million	Adjusted Annual % Change	Credit to Households for House Purchase, €Million	Credit to Households for House Purchase, Annual % Change	Irish Private Sector Deposits, €Million	Households' Deposits, €Million
<b>2008</b>	March	154,717	14.5	125,091	15.5	175,272	83,352
	June	151,289	13.3	121,260	14.2	176,929	84,301
	September	153,320	12.1	122,791	12.7	179,204	85,251
	December	144,576	8.3	114,978	9.8	176,207	85,247
<b>2009</b>	March	148,800	6	114,266	7.8	182,192	97,566
	June	147,943	2.9	114,306	4.8	183,839	98,462
	September	141,327	0.2	110,146	1.9	182,782	98,076
	December	140,085	-1.1	110,210	0.6	183,761	99,148
<b>2010</b>	March	137,345	-2.6	109,434	-0.2	183,625	98,115
	June	140,188	-4.5	107,676	-1.5	180,420	97,253
	August	139,078	-3.9	107,411	-0.7	178,696	96,470

The new statistics provide information on transactions or flows of credit on a monthly basis. The net flow of lending to the household sector was €228 million during August 2010, the first positive net monthly flow in 2010. Prior to August, the net flow of household lending had been negative in fourteen of the previous eighteen months as the repayment of loans by the household sector exceeded the drawdown of new credit. The positive net flow of household lending during August was the result of loan

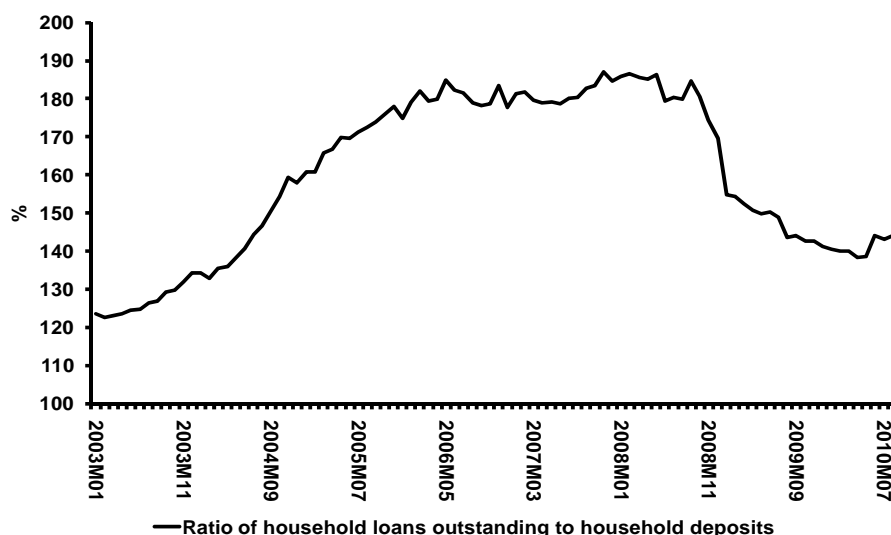
<sup>17</sup> The Central Bank published the new series of money and credit data in *Money and Banking Statistics* in August 2010. This release replaces the previously published *Monthly Statistics*. The credit growth rates published in this release are based solely on underlying transactions and exclude all valuation effects including foreign exchange movements, increased provisions or write-downs and reclassifications etc.

drawdowns relating to house purchase exceeding loan repayments by €309 million. The net flow of lending for consumption remained negative (-€84 million) during August for the fourteenth consecutive month.

Lending to the non financial corporate (NFC) sector<sup>18</sup> accounts for around 34 per cent of the stock of private sector credit outstanding. The annual rate of change in loans to this sector has been negative since late 2009 and that trend has continued during 2010. The decline in lending to the NFC sector has been driven by the contraction in longer-term loans; the stock of these loans fell by almost 11 per cent on an annual basis in August 2010. In contrast, the rate of change in NFC loans of up to one year maturity (includes the use of short-term credit facilities such as overdrafts) has remained positive over the course of 2009 and 2010. Growth in short-term NFC loans averaged 6.3 per cent in the three months to August 2010.

Household deposits account for over half of total private sector deposits in Irish resident credit institutions. The annual rate of change in household deposits fell sharply during 2009 and 2010 and turned negative in May 2009 (Table 15). Despite this recent decline, the level of household deposits in August 2010 was 13 per cent higher than in August 2008. At the same time, the level of household sector debt outstanding has been declining due to increased write-downs and bad-debt provisions as well as the repayment of debt exceeding the new drawdown of credit since late 2009. As a result, the ratio of household loans outstanding to household deposits has declined sharply over the course of 2009 and 2010 as shown in Figure 24.

**Figure 24: Ratio of Household Loans to Household Deposits**

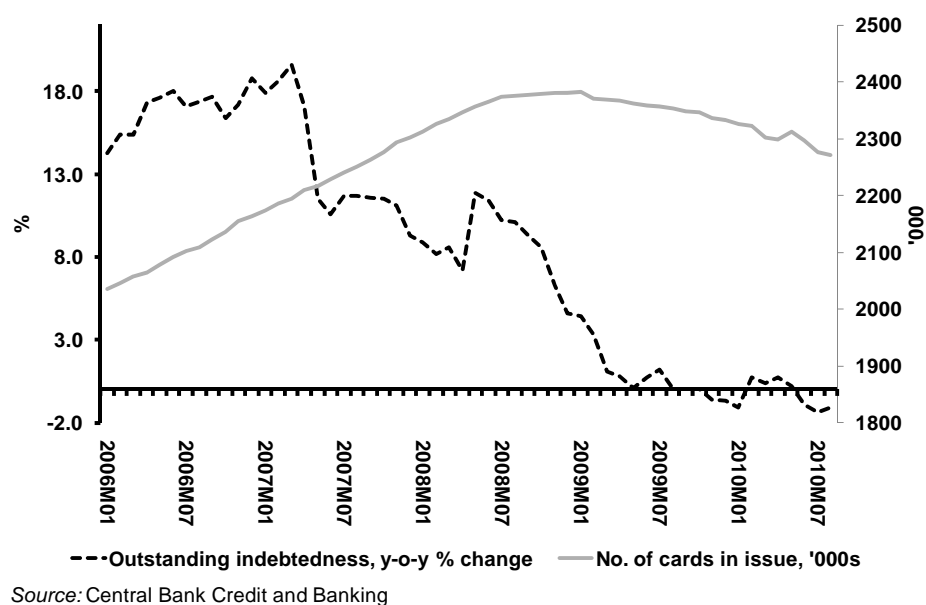


Source: Money and Banking Statistics, Central Bank.

<sup>18</sup> This is defined as private and public institutional units involved in the production of goods and non-financial services.

Reflecting the weakness in consumer spending, the number of credit cards in issue declined for sixteen consecutive months between February 2009 and April 2010. The number of cards in issue increased during May before falling in each of the three months to the end of August 2010. As shown in Figure 25, the number of credit cards in circulation at the end of August 2010 was back to the level of September 2007. The year-on-year growth in outstanding credit card debt moderated sharply over the course of 2008 and 2009 as shown in Figure 25 with the rate of change turning negative in early 2010. Personal indebtedness on credit cards stood at just over €3 billion in August 2010, a reduction of over 1 per cent compared to August 2009.

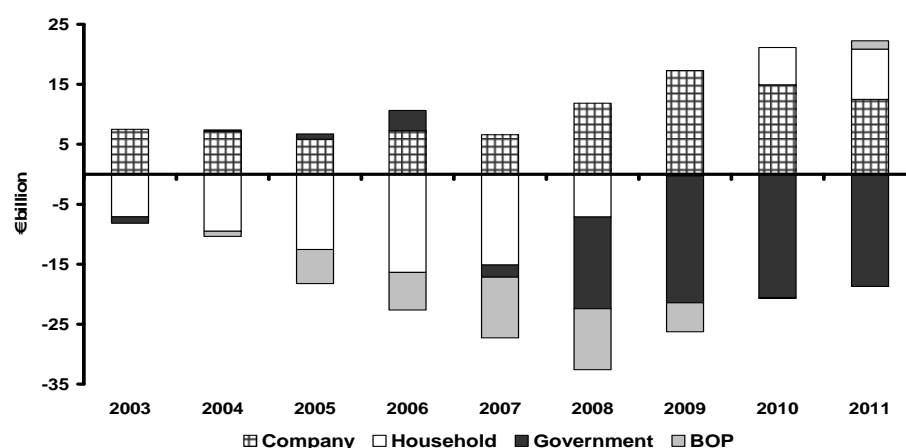
**Figure 25: Credit Card Statistics**



Deleveraging by the household and company sector, as shown in the latest statistics on private sector debt outstanding, is reflected by developments in the flow of funds in the Irish economy (Figure 26). The household sector recorded large deficits between 2003 and 2008 related to the increase in households' borrowing to fund investment in housing. Our forecasts imply that as a result of the decline in the financing needs of the household sector as well as the increase in the savings rate, the rate of net acquisitions of the household sector should remain in surplus in 2010 and 2011. As the private sector continues to repair its balance sheet, this should contribute to a reduction in the overall liabilities of the banking system.



**Figure 26: Flow of Funds in the Irish Economy**



Source: Balance of Payments Statistics and Own Calculations

## Credit Conditions

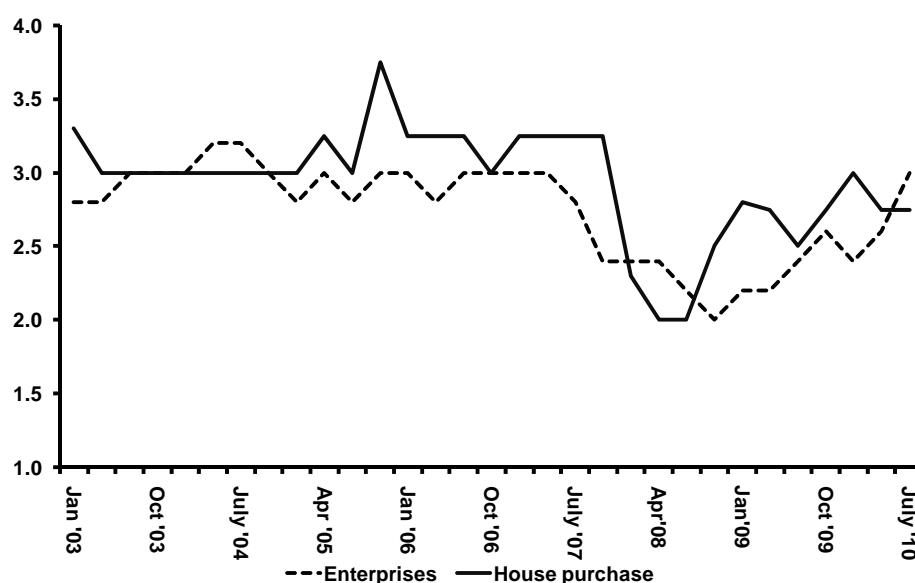
The latest Irish results from the Euro Area *Bank Lending Survey* point to an ongoing tightening in credit supply standards to both households and enterprises while demand for credit also remains weak. Credit standards on loans to enterprises were unchanged during Q2 2010 but tightened marginally on loans to households for house purchase, as shown in Table 16 and Figure 27. Increased risk perception contributed to the tightening of credit standards on loans to enterprises while the cost of funds and balance sheet constraints were the factors cited as affecting credit standards on loans to households for house purchase.

**Table 16: Irish Responses to ECB *Bank Lending Survey*, Change in Credit Standards from Previous Quarter**

		Q2 2009	Q3 2009	Q4 2009	Q1 2010	Q2 2010
<b>Enterprises</b>	Overall	2.4	2.6	2.4	2.6	3
	Loans to SMEs	2.75	3	2.75	3	3
	Loans to large enterprises	2.25	2.5	2.25	2.5	3
	Short-term loans	2.4	2.6	2.4	2.6	3
	Long-term loans	2.4	2.6	2.4	2.6	3
<b>Households</b>	House purchase	2.5	2.75	3	2.75	2.75
	Consumer credit and other lending	2.75	3	3	2.75	3

1 = tightened considerably; 2 = tightened somewhat; 3 = basically unchanged; 4 = eased somewhat; 4 = eased considerably.

**Figure 27: Credit Supply Conditions as Reported by Banks, Change from Previous Quarter**



Source: Euro Area Bank Lending Survey, ECB.

Figure 27 shows that credit standards on loans to households and enterprises have been tightening since mid-2007. Banks were asked two ad-hoc questions in the July version of the *Bank Lending Survey*. Irish banks reported that access to wholesale markets deteriorated over the previous three months and that they expected a further deterioration over the next three months. In addition, banks responded that ongoing financial market uncertainty continued to impact their capital position. Both of these factors have contributed to the tightening in credit standards which has taken place since 2007 (Figure 27).

## BANK FUNDING

As noted in previous *Commentaries*, in discussing the liabilities of the banking system it is important to distinguish between the liabilities of Irish owned banks and the liabilities of all credit institutions located in Ireland. At the end of August 2010, the liabilities of all financial institutions resident in Ireland amounted to €1,309 billion. However, the liabilities of Irish owned banks were €582 billion, less than half of total liabilities, and not all of these are covered by the government guarantee.<sup>19</sup> The difference between the figure for total liabilities and the liabilities of Irish owned banks is due to the presence of foreign credit institutions in Ireland, mostly IFSC companies.

Since the heightening of tensions in interbank lending markets in late 2008, the Eurosystem has provided liquidity to Central Banks through its Longer Term Refinancing Operations and through the adoption of a series of non-standard measures. The adoption of these measures contributed to

<sup>19</sup> The total value of liabilities covered by the Eligible Liabilities Guarantee Scheme at 30 June 2010 was €153 billion. An updated figure for the value of guaranteed liabilities will be available from mid-November.

a gradual improvement in money market conditions over the course of 2009 and early 2010. The contagion from the Greek sovereign debt crisis during April and May caused renewed tension in Euro Area bank funding markets. As a result, the ECB announced the establishment of the Securities Markets Programme (SMP)<sup>20</sup> as well as the continuation of its 3-month and 6-month longer-term refinancing operations.

Credit institutions' borrowing from the Irish Central Bank as part of Eurosystem monetary policy operations peaked in June 2009 at over €130 billion, equivalent to over a fifth of total Eurosystem net lending to credit institutions in the Euro Area (Table 17 and Figure 28). Credit institutions borrowing from the Central Bank fell for 5 consecutive months from mid-2009 signalling a reduction in banks' dependence on Central Bank funds.

**Table 17: Credit Institutions' Borrowing from the Central Bank in Millions**

		<b>Borrowing from the Eurosystem Relating to Monetary Policy Operations</b>	<b>Eurosystem Net Lending to Euro Area Credit Institutions in Euro, Related to MPO</b>	<b>Irish Share</b>	<b>Credit Institutions' Borrowing from the Central Bank, % of GDP</b>
<b>2007</b>	March	24,020	421,633	5.7	12.7
	June	25,535	438,038	5.8	13.5
	September	23,751	420,169	5.7	12.5
	December	39,449	475,324	8.3	21.0
<b>2008</b>	March	34,395	483,600	7.1	19.0
	June	38,373	460,645	8.3	21.2
	September	58,671	471,362	12.4	39.2
	December	88,562	613,857	14.4	54.0
<b>2009</b>	March	120,628	607,356	19.9	79.8
	June	130,423	615,980	21.2	83.9
	September	91,573	583,939	15.7	53.9
	December	90,899	564,495	16.1	56.9
<b>2010</b>	March	82,573	511,471	16.1	52.0
	June	90,473	534,859	16.9	56.9
	August	95,062	427,252	22.2	59.8
	September <sup>21</sup>	119,106	446,830	26.7	75.0

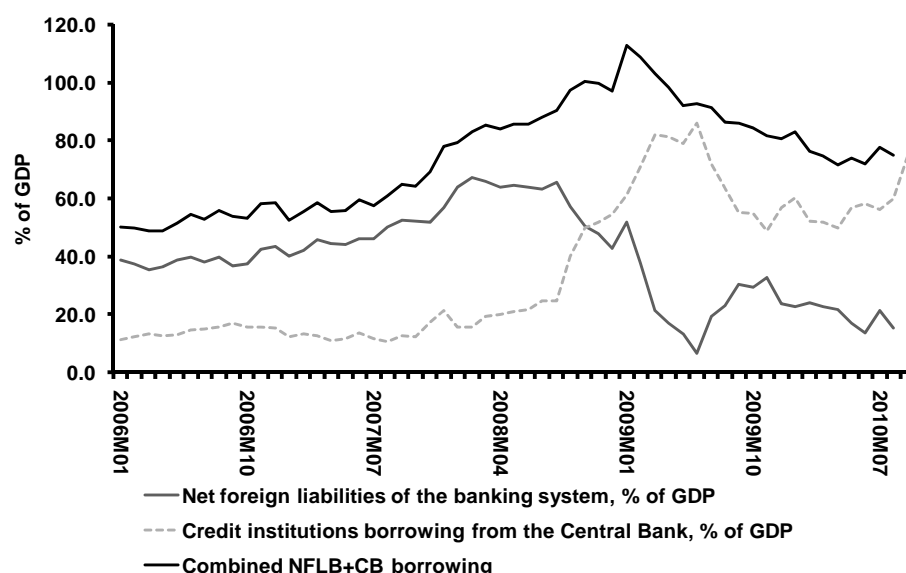
<sup>20</sup> Under the SMP, the Eurosystem will purchase Euro Area public and private debt securities in secondary markets in order to enhance liquidity in these markets. To sterilise the impact of these interventions, specific operations will be conducted to re-absorb the liquidity injected through the Securities Markets Programme.

<sup>21</sup> The figure for September relates to lending to Euro Area credit institutions relating to monetary policy operations. The September figure for banks' borrowing from the Eurosystem relating to monetary policy operations is not yet available, however, the two series have tracked each other closely over recent years.

However, recent months have seen a reversal of this trend with credit institutions' borrowing from the Central Bank reaching €95.1 billion in August and almost €120 billion in September, equivalent to 75 per cent of GDP and over a quarter of total Eurosystem net lending to Euro Area banks. The sharp increase in banks' borrowing from the Central Bank in September coincided with the maturity of a large quantity of Irish banks' bonds during the month. This highlights the ongoing difficulty faced by Irish banks in accessing wholesale funding markets since the second quarter of this year, as reflected in the responses to the *Bank Lending Survey* discussed earlier.

The level of credit institutions' borrowing from the Central Bank (related to Eurosystem monetary policy operations) in recent months is evidence of the importance to the Irish banking system of the measures introduced by the ECB in order to ensure depth and liquidity in Euro Area bank funding markets at a time of heightened tensions.

**Figure 28: Net Foreign Liabilities of the Banking System and Banks' Borrowing from the Central Bank, % of GDP**



Source: Money and Banking Statistics, Central Bank.

## Latest Steps in Resolving the Banking Crisis

On September 30 the government and the Central Bank announced the latest in a series of measures aimed at resolving the banking crisis and ensuring that Irish banks are in a position to lend to households and businesses as the economy recovers. The section below contains a timeline of the measures implemented by the government since September 2008 in response to the financial crisis.

The estimates of the cost to the State of government support to the banking system have increased a number of times since late 2008. Table 18 details the level of State support to the banking system based on the announcements by the authorities on September 30. The potential fiscal costs of the current crisis can be separated into three different elements:

- The recapitalisation of Bank of Ireland, AIB and EBS;

- The recapitalisation of Anglo Irish Bank and Irish Nationwide Building Society and;
- National Asset Management Agency (NAMA).

The gross cost of the recapitalisation of the five main Irish banks currently stands at over €42 billion, or 26 per cent of GDP. Assuming that the State will eventually recoup the value of its investments in Bank of Ireland, AIB and EBS, the net cost to the state of the bank rescue could amount to almost €35 billion or 22 per cent of GDP. This figure is based on the authorities' most recent estimate of the level of capital required by Anglo Irish Bank and Irish Nationwide Building Society.

The Central Bank has determined that under a severe stress scenario, the gross cost of the recapitalisation of Anglo Irish Bank could increase by €5 billion to almost €35 billion. In addition, the State is likely to have to invest a further €3.7 billion in AIB in order to ensure that the bank meets the regulator's capital target by the end of 2010.<sup>22</sup> Including the cost of covering the potential additional losses in Anglo Irish Bank increases the estimate of the eventual net cost of the bank bailout to €39.7 billion or 25 per cent of GDP.

**Table 18: Overview of Existing and Estimated State Support to the Banking System**

<b>Cost of Bank Recapitalisation</b>	<b>€billion</b>	<b>% of GDP</b>
Allied Irish Bank (1)	3.5	2.2
Bank of Ireland (2)	3.5	2.2
EBS Building Society (3)	0.4	0.2
Anglo Irish Bank (4)	29.3	18.4
Irish Nationwide Building Society (5)	5.4	3.4
Total gross cost to date (6)=(1+2+3+4+5)	42.1	26.3
Total net cost to date (7)=(4+5)	34.7	21.7
Potential Additional Cost		
Anglo Irish Bank (8)	5.0	3.1
AIB (9)	3.7	2.3
Total potential gross cost (10)=(6+8+9)	50.8	31.8
Total potential net cost (11)=(7+8)	39.7	24.9
Payment planned for loans under NAMA (12)	40.0	25.1
Total government involvement in the banking system (13)=(10+12)	90.8	56.8

<sup>22</sup> On September 30, the government announced that the National Pension Reserve Fund Commission (NPRFC) would underwrite in full the placing and offer to AIB shareholders of AIB shares to the value of €5.4 billion. If necessary, the underwriting commitment will be met by the conversion of up to €1.7 billion of the NPRFC's existing preference shares into ordinary shares along with a new cash investment of €3.7 billion. Any further shortfall in the bank's capital requirement will be met by the conversion of a proportion of the bank's remaining €1.8 billion preference shares.

The figures for the net cost of the bank rescue in Table 18 assume that the State recovers in full the value of its investments in Bank of Ireland, AIB and EBS. In return for the dividend owed to the State in respect of the preference shares it received under the recapitalisation agreement, the NPRF has acquired substantial stakes in both Bank of Ireland and AIB as documented in the section below. It should be noted that although the State's investments (through the NPRF) in Bank of Ireland and AIB may eventually yield a return, this has not been a costless transaction. As shown in the *NPRF's Annual Report* for 2009, the fund's Discretionary Investment Portfolio (the NPRF excluding the preference shares held in Bank of Ireland and AIB) earned a return of 20.6 per cent in 2009. This compares to a return of zero in the fund's Directed Investments in Bank of Ireland and AIB.<sup>23</sup> This indicates that a potential gain of €1.4 billion was foregone in 2009, assuming that the €7 billion invested in the two banks could have earned a return similar to the fund's Discretionary Investment Portfolio.

At between 22 and 25 per cent of GDP, the current estimate of the net fiscal cost of resolving the banking crisis is manageable but, nonetheless, represents an enormous cost to the State at a time of unprecedented economic challenges. In addition to the fiscal cost, Honohan (2002)<sup>24</sup> identifies two other channels through which a banking crisis impacts on the macroeconomy. The first of these is the stock component – the waste of resources, which would include the houses built that are unlikely ever to be occupied, the costs incurred by those who fail to meet their mortgages, and the wipe out of important financial institutions. The second, which Honohan refers to as the flow component, is the slump in the economy that has occurred as a result of the banking crisis. While it will only be possible to determine the full impact of these channels over time, both of these costs, in addition to the fiscal costs, have greatly aggravated the pain of the banking crisis in Ireland.

## **Measures implemented by the Government (September 2008 – September 2010) in Response to the Financial Crisis**

### **20 September 2008 Statutory Deposit Guarantee:**

Increase in the statutory limit for the deposit guarantee scheme for banks and building societies from €20,000 to €100,000 per depositor per institution. The cover applies to 100 per cent of each individual's deposit.

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<sup>23</sup> Bank of Ireland and AIB were due to pay €250 million and €280 million respectively as cash dividends on the NPRF's preference share investments in the two banks. The European Commission have requested that discretionary coupon payments on tier 1 and upper tier 2 capital instruments in Bank of Ireland and AIB, which includes the government preference shares, not be paid while they discuss the banks' restructuring plans. In lieu of the dividend payments, the state has acquired ordinary shares in both banks.

<sup>24</sup> Honohan, P., 2002. 'Comment on "Costs of Banking System Instability: Some Empirical Evidence"', *Journal of Banking and Finance*, Vol.26, No. 5, pp. 857-860.

**30 September 2008      Credit Institutions (Financial Support) Scheme 2008:**

Guarantee arrangement with six Irish financial institutions<sup>25</sup> to safeguard *all* deposits (retail, commercial, institutional and inter-bank), covered bonds, senior debt and dated subordinated debt (lower tier II), effective from 30 September 2008 until 29 September 2010. The guarantee is provided at a charge to the institutions concerned and is subject to specific terms and conditions. This guarantee scheme was also offered to certain foreign-owned banks<sup>26</sup> on 9 October. In June 2009 legislation was passed allowing for the extension of this guarantee arrangement beyond September 2010 if deemed necessary by the Minister for Finance.<sup>27</sup>

**21 January 2009      Nationalisation of Anglo Irish Bank:**

As result of both a weakening of the bank's funding position and the serious reputational damage arising from unacceptable practices within the bank, Anglo Irish Bank was taken into public ownership.

**11 February 2009      Recapitalisation of AIB and Bank of Ireland:**

Agreement reached on a recapitalisation package, with the main features of the government's investment as follows<sup>28</sup>:

- The government will provide €3.5billion in Core Tier 1 capital for each bank. In return, the Minister will get preference shares with a fixed dividend of 8 per cent payable in cash or ordinary shares in lieu.
- The recapitalisation programme will be funded from the National Pensions Reserve Fund. €4billion will come from the Fund's current resources while €3billion will be provided by means of a frontloading of the Exchequer contributions for 2009 and 2010.

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<sup>25</sup> Allied Irish Banks, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and the Educational Building Society (EBS).

<sup>26</sup> Ulster Bank, First Active, Halifax Bank of Scotland, IIB Bank and Postbank.

<sup>27</sup> Financial Measures (Miscellaneous Provisions) Bill 2009.

<sup>28</sup> For full details see [www.finance.gov.ie](http://www.finance.gov.ie)

**7 April 2009**

**National Asset Management Agency (NAMA):**

In the Supplementary Budget, the government announced plans for a National Asset Management Agency, which will operate as an independent commercial entity under the aegis of the National Treasury Management Agency (NTMA):

- The NAMA will buy property-related loans of between €80billion and €90billion from the covered banks at an appropriate discount and will pay for them by the issue of Irish Government bonds directly to the banks.
- The income from the assets and the proceeds from their eventual sale will accrue to the NAMA and will mitigate the cost to the Exchequer of servicing the additional debt. If on wind-up the NAMA has made a profit, this will accrue to the State. If it makes a loss, the government will apply a levy to the banks to recoup the shortfall.

**29 May 2009**

**Anglo Irish Bank Capital Injection:**

Following publication of Anglo Irish Bank's financial results for the six months to March 31, the government announced plans to provide €4billion of capital to Anglo Irish Bank, pending EU approval.

**09 December 2009**

**Eligible Liabilities Guarantee Scheme (ELG) 2009 Introduced:**

ELG provides for an unconditional State guarantee for certain eligible liabilities (including deposits) up to five years in maturity incurred by participating institutions from the date they joined the ELG scheme to 31 December 2010. The ELG allows banks to issue debt maturing later than September 2010. Eligible bonds and deposits with maturities of up to 5 years are guaranteed out to maturity.

**19 February 2010**

**Conversion of Preference Share Stake in Bank of Ireland:**

The State acquires a 16 per cent shareholding in Bank of Ireland as the NPRF is issued with €250 million worth of ordinary shares in lieu of the dividend owed to the State in respect of the



preference shares it received under the recapitalisation agreement.

**30 March 2010**

**Banking Statement by the Minister for Finance:**

Government announces that it is providing a further €8.3 billion to Anglo Irish bank via the issue of a promissory note and that a further €10 billion could be required. New capital raising targets to be met by December 31 2010 are set by the Financial Regulator for the remaining banks; Bank of Ireland must raise €2.7 billion, AIB €7.4 billion, EBS €875 million and INBS €2.6 billion. The €2.6 billion for INBS will be injected via the issue of a promissory note from the State. €100 million will be given to EBS via the issue of special investment shares.

The Minister announces the transfer of the first tranche of loans to NAMA. Loans with an original book value of €16 billion are purchased by the agency for €8.5, a weighted average discount or haircut of 47 per cent.

**13 May**

**Conversion of Preference Share Stake in AIB:**

In lieu of the annual €280 million cash payment on the NPRF's preference share investment, the Fund receives ordinary shares giving it an 18.6 per cent shareholding in the bank.

**31 May**

**Further Recapitalisation of Anglo Irish Bank:**

The government injects a further €2 billion into Anglo, part of the additional €10 billion that the government indicated on March 30 could be needed to cover the bank's losses.

**16 June**

**EBS Recapitalisation:**

The government confirms that it has provided €250 million via the issue of a promissory note to fund the recapitalisation of EBS. This is in addition to the €100 million already committed through the issue of special investment shares.

**23 August**

**NAMA Tranche 2 Transfers:**

NAMA completes the transfer of a second tranche of loans with a nominal value of €11.9 billion. The loans are purchased for €5.28 billion, a weighted average discount of 55.6 per cent.

**31 August**

**Anglo Results and Recapitalisation:**

Following the publication of Anglo accounts for the first half of 2010, which show losses of €8.2 billion, the Minister for Finance announces that the bank has been recapitalised with a further €8.58 billion effective 30 June 2010. This brings the total cost of the Anglo bailout to €22.88 billion.

**8 September**

**Decision to Split Anglo Irish Bank:**

The government decides to split Anglo Irish Bank into a funding Bank and an asset recovery bank. The funding bank will be a government guaranteed deposit bank while the asset recovery bank is to work out Anglo's non-NAMA loans over a period of time. The plan requires EU Commission approval.

**29 September**

**CIFS Guarantee Scheme Expires:**

The blanket guarantee scheme, the Credit Institutions Financial Support Scheme, expires. The ELG scheme remains in place up to 31 December 2010. The ELG covers liabilities incurred between the date a financial institution joined the scheme and 31 December 2010. The ELG provides a government guarantee of debts issued with maturities of up to 5 years out to their maturity. Dated subordinated debt is not guaranteed under the terms of the ELG.

**30 September**

**Banking Statement from Government and Central Bank**

Based on an assessment by the Central Bank, it is announced that Anglo Irish Bank will require a further €6.4 billion and that on the basis of "severe stress assumptions" it could require an additional €5 billion. A further €2.7 billion is to be provided to INBS to cover its losses (see Table 18).

AIB is advised by the Central Bank that it will be required to raise an additional €3 billion by 21 December 2010 on top of the €7.4 billion requirement announced by the Regulator in March. The authorities announce that the bank is "...unlikely to be able to conduct a traditional privately underwritten transaction" with the result that a new cash investment by the state of €3.7 billion could be required. In addition, it is

announced that a substantial proportion of the NPRF's preference shares in AIB will be converted into ordinary shares to ensure the bank meets the Central Bank's capital raising target. It is also signalled that any residual capital shortfall will be met by the conversion of the remaining €1.8 billion preference shares.

The government announces that the support being provided to the banks will add 20 per cent of GDP to Ireland's General Government Deficit in 2010, pushing the overall deficit for the year to 32 per cent.

**30 September 2010** It is announced also that the government has decided that where the total exposure of a debtor is below a €20 million threshold in Bank of Ireland and AIB, that debtor's loans will not now be transferred to NAMA. The previous threshold was €5 million. There are 650 debtors with property related debts of between €5 and €20 million amounting to around €6.6 billion of the aggregate €80 billion volume of eligible NAMA loans.

# GENERAL ASSESSMENT

All recent *Commentaries* have been written against a background of national economic crisis. With output levels apparently stabilising, with the falls in employment easing and with tax revenues “on target”, there might have been reason to assert that the crisis was at least easing. However, a range of severe difficulties still face the economy and in the case of at least one, Ireland’s capacity to borrow on international markets, difficulties have become more acute. As the full cost of the banking bailout has emerged, international markets appear to have become increasingly concerned about Ireland’s capacity to deal with both the banking and public finance crises. The emerging picture of the banks has also indicated that the presence of a healthy banking system in the Irish economy is further away than we might have thought.

It is against this background that the government must soon announce its four-year programme of fiscal austerity. As we have shown above, it is possible that this programme will involve savings of up to €15 billion. Those figures are based on the Low Growth scenario from the Institute’s *Recovery Scenarios* paper published in July. A High Growth scenario was published then also and under that scenario, a less draconian set of savings is needed. Our view is that the European Commission is more likely to use a growth profile closer to our low growth scenario when assessing Ireland’s fiscal requirements. Consequently, we focus the discussion around the savings range of €15 billion and around the preferred timeframe of fiscal adjustment under the low growth scenario. If the high growth scenario from our July publication were to prevail, there is a possibility that more adjustment will be imposed than is actually needed. An austerity programme of this magnitude, confined to a four year period, will clearly have severe implications for economic growth. The low growth scenario that was presented in the Institute’s *Recovery Scenarios* paper envisaged an annual average growth rate of 3¼ per cent per annum out to 2014. Our calculations suggest that this growth rate would be reduced to 2¼ per cent as a result of this much larger adjustment package compared to the original package of €7.5 billion announced in the 2010 Budget.

Before discussing further the implications of the austerity programme, it is important to note that we have grave doubts over the wisdom of the parameters of an austerity programme where such a high levels of savings will be sought in such a tight time frame. A restoration of sustainability in the public finances is needed, of that there is no doubt. But to us, if one accepts the ESRI’s Low Growth scenario as being a reasonable depiction of how the Irish economy might grow in the coming years, a longer time frame for adjustment would be preferable. The problem arises because an austerity package of €15 billion within four years could damage the

potential of the economy to grow its way out of recession. The scale and speed of adjustment is such that it will be exceptionally challenging to retain societal support. From our perspective, an agreement with the European Commission to reduce the deficit to 3 per cent by 2016 would have been preferable and would have been seen as being credible by international lenders, once EU agreement had been achieved.

While the 2014 date strikes us as worryingly ambitious, we are mindful that an extension is highly unlikely and so we must operate within the constraints as presented. Although we have based our forecasts on a budgetary package of €4 billion of savings, it could well be that a higher amount will be sought. Whatever it is, the scale of the task is such that there will be a need for adjustments in current and capital spending and in taxation.

With regard to current spending, the menu of options that was presented in the report of the Special Group on Public Service Numbers and Expenditure Programmes, commonly referred to as An Bord Snip Nua, remains the most comprehensive overview of what might be done. Given the scale of what we now face, it may be necessary to explore whether or not the scope of that exercise is adequate to the current situation. It is important to recognise that the quality of the decisions we make in relation to the cuts will have a bearing on the rate of our long-term recovery.

As so many of the savings outlined in that report relied on shrinking numbers in the public sector, we are forced to raise the question of whether the Croke Park deal may need to be revisited and, in particular, if mandatory redundancies in the public sector might have to form part of the adjustments. Of course, the agreement that there would be no further cuts in pay in the public sector is the other element of the Croke Park deal which, might now also have to be re-opened.

On taxation, the Report of the Commission on Taxation provides an analysis of many relevant issues. Options such as the introduction of a property tax and the application of water charges are simple elements in any rational tax system. Even in the absence of a fiscal crisis, they should be introduced but the current imperative is overwhelming. The broadening of the tax base, especially by reducing extent of tax expenditures that grew in the past decade, also provides an opportunity both to improve the operation of the tax system and to raise necessary revenue.

While we are deeply concerned about the austerity road which Ireland will have to pursue in the coming years, it seems that we have little room for manoeuvre as a result of the policies that were pursued in the early and middle parts of the last decade. The weak system of banking regulation and the growth in public spending which relied on transient sources of revenue contributed to bringing Ireland to this point. It is to be hoped that there will be beneficial dimensions to the austerity programme but the challenges are immense.

# RESOURCE ALLOCATION, FINANCING AND SUSTAINABILITY IN THE HEALTH SECTOR

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## Introduction

The focus on acute, episodic care in the conventional health-care model fails to provide adequately for changing health-care needs arising from increased longevity and increasing prevalence of chronic disease. Integrated care involves coherent and co-ordinated delivery of health-care services across a broad range of health and social care providers. A principal aim of integrated health care is to improve the patient's journey through the system by co-ordinating care among providers and by strengthening the role of primary care. Effective resource allocation mechanisms, supported by appropriate financing arrangements, have an important role to play in delivering integrated health care. In addition, more efficient use of scarce health-care resources is required, and can be influenced by the resource allocation and financing mechanisms. This article summarises research undertaken by the ESRI to provide evidence for the Expert Group on Resource Allocation and Financing in Health Care, which reported in July 2010 (Brick et al., 2010a, b; Ruane, 2010). The research:

- reviewed the theoretical and international empirical literature on resource allocation, financing and sustainability in health care (focusing on eight comparator countries – Australia, Canada, Germany, Netherlands, New Zealand, Sweden, UK, USA);
- evaluated current Irish systems of resource allocation and financing and issues associated with sustainability;
- proposed a framework for health-care entitlements and user fees that would support the delivery of integrated health care in Ireland.

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## Sustainability

It is important to provide an overview of trends in the overall level of resources available for health, and the drivers of increased health-care expenditure. Since 2000, Irish public health expenditure has more than doubled in real terms to reach a level of over €15bn in 2009. It accounted for almost 12 per cent of national income in 2009, up from 6.3 per cent in 2000. Health care accounted for about one in every four euros of total public expenditure throughout the last decade. Concerns about sustainability are not unique to Ireland; total per capita expenditure on health increased by an average of 6.4 per cent per annum across the EU-15, Australia, Canada, New Zealand and the US over the period 2000-2007.

Several studies have found that national income is the single most important driver of public health expenditure, with increases in income leading to proportionately equal increases in health expenditure. Other important factors include demographic change and an increasing burden of chronic disease, as well as supply-side factors such as rising medical prices, technological change, increasing capital stock and labour costs, the regulatory regime governing behaviour in the health sector and the incentive structure facing health-care providers are also important. In Ireland, while the size of the population increased by 17.7 per cent over the period 2000-2009, the share of the population aged over 65 years actually declined slightly over the period. The growth in national income was much more substantial, as was the change in both the overall price level and the change in health prices.

Particular concern over sustainability has arisen with regard to state expenditure on pharmaceuticals and payments to pharmacists. Approximately 85 per cent of total expenditure on pharmaceuticals in Ireland relates to state expenditure on pharmaceuticals and payments to pharmacists under the General Medical Service (GMS) Scheme and community drugs schemes (CDS). Expenditure on the GSM Scheme alone has increased from €831m in 2005 to €1.3bn in 2009 (195 per cent in real terms). The growth can be explained by a combination of increases in the price (e.g. newer, more expensive drugs) and volume (e.g. increase in eligibility) of drugs prescribed. Recent attempts to control this expenditure have focused largely on two particular measures, namely, attempting to secure better value for money via amendments to the pricing and reimbursement mechanisms on the GSM and CDS, and increasing the degree of cost sharing on the part of patients.

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## Resource Allocation

Internationally, the concept of population health need is being used to allocate health-care resources, in contrast to traditional methods driven by historic allocations to existing providers and facilities. In Ireland, resources are allocated largely on an historic funding basis, notwithstanding recent attempts to move to a more rational allocation of resources for some services (e.g. services for older persons).

Even when allocations are made on the basis of population health, the extent of ‘purchaser-provider split’ and methods of provider reimbursement can have important implications for the degree to which providers are financially incentivised to deliver appropriately integrated health care. One of the main advantages of segregating the purchasing and providing functions is the ability to employ financial incentives and monitoring tools to encourage providers to offer services more efficiently. While there is strict separation between the purchaser and provider in many aspects of Irish health care (e.g. between the HSE and GPs), other relationships are not characterised by such a split (e.g. the HSE owns and funds more than half of acute public hospitals).

Provider reimbursement can be activity-based (e.g. per number of patients/cases treated, treatment intensity or duration). This method could stimulate activity, but may be less effective at controlling costs than other reimbursement systems (such as global budgets or fixed salaries). The consensus which emerges from research is that no single payment mechanism can achieve all of the stated health-care objectives; rather, a mix of reimbursement types is required.

For the remuneration of GPs, most countries use a mixture of capitation and fee-for-service remuneration, with salary payments less common. Many countries are also now experimenting with pay-for-performance elements, whereby GPs face financial incentives for chronic disease management, appropriate prescribing, data collection, etc. The Irish system is unusual in that methods of GP remuneration depend on patient type; predominately capitation for medical card patients, and fee-for-service for private patients. The conflicting incentives on the part of GPs that arise from this distinction do not facilitate the delivery of integrated health care.

Casemix funding (prospective, activity-based payments) is now the preferred hospital reimbursement mechanism in six of the eight countries studied. Despite some common objectives for casemix funding, implementation varies considerably across countries, making it difficult to evaluate the system's impacts on activity, length of stay, quality and costs. For treating public patients, Irish public hospitals receive budgetary allocations, predominantly determined by historic factors. A subset of hospitals receives a retrospective budgetary adjustment for treatment complexity and relative performance. The planned move to prospective casemix funding should improve the transparency between payment and activity. Of some concern are potential perverse (and conflicting) incentives generated by the different mechanisms used to reimburse Irish public hospitals and their consultants for public and private patients (e.g. consultants in public hospitals receive a salary for treating public patients but a fee-for-service for private practice).

Crucial for integrated care is the alignment of financial incentives not only within, but also between, all sectors of the health-care system. Many international initiatives have sought to improve integration; however, these schemes generally fail to co-ordinate care across multiple conditions and lack formal evaluation. In Ireland, the HSE established the Integrated Services Directorate in 2009. While necessary, such organisational reforms are not sufficient for integration. Further development of primary care in particular is required, as well as financial incentives that are consistent across providers and patients.

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## Financing

Without resources, there is nothing to allocate. How resources are generated can affect the resource allocation process. In Europe, the main health care financing sources include public taxation, social health insurance, private health insurance and out-of-pocket payments. In Ireland, public taxes account for the largest proportion of health care financing (approximately 80 per cent) followed by out-of-pocket payments and private health insurance. Health systems are often grouped according to the dominant source of financing (e.g. tax-based systems). However, as the mix of health resource mechanisms is becoming more complex, it is more logical to assess the merits or otherwise of each individual mechanism separately.



Tax and social health insurance contributions both introduce separation between what people pay for health care, and what they receive. This allows the principles for collecting resources from individuals (e.g. according to ability to pay) to be separate from the principles determining how those resources are allocated (i.e. population health need). With social health insurance there is a clear, observable link between available health-care resources and health-care entitlements; although this transparency can be reduced where social health insurance is supplemented by tax-based resources. International evidence indicates that there are ways of introducing many of the desired features of social health insurance in a tax-based system. In the Irish context, policy-makers need to address problems of poor transparency around public tax-based resources, in particular the complications associated with public subsidisation of private health care activity.

Out-of-pocket payments are directly linked with the individual's use of the service. These payments are outside the public resource allocation process. International evidence indicates that user fees discourage both necessary and unnecessary utilisation, and have negative implications for equity and there is evidence of this in Ireland. The requirement for non medical cardholders, the majority of the population, to pay out-of-pocket for GP care is unique to Ireland compared with other developed countries. An inconsistent structure of user fees across community, primary and acute care means that non medical cardholders are not always directed to the most appropriate location for their care. These features interrupt the delivery of integrated health care. Incentives facing patients and providers need to be aligned so as to ensure that health problems are diagnosed at the earliest opportunity, that there is continuity of care for people with chronic conditions and that the most appropriate care takes place in the most appropriate location.

To support this process, a coherent framework of entitlements and user fees is proposed. Within the framework, a set of graduated subsidies are available for GP care, prescription medicines and other care for the whole population (people on lower incomes would receive higher levels of subsidy). Subsidisation of chronic conditions would also be streamlined to address existing inconsistencies (e.g. exclusion of certain critical conditions from the Long-Term Illness Scheme). The framework removes the large jumps in entitlement that are currently in place (e.g., where income increases above the GP Visit medical card eligibility threshold, the user fee for GP care increases from zero to the full private charge). The framework also introduces greater separation between payment for health care and people's risk of ill health by reducing the extent to which health care is paid for at the point of use.

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# INTERNATIONAL TRANSMISSION OF BUSINESS CYCLES

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Increased international economic integration over the past two decades has stimulated a growing academic and policy interest in the analysis of the international transmission of business cycles. There has been renewed interest recently in this research topic notably in relation to the current global financial and economic crisis. In an increasingly integrated world economy, understanding the extent to which business cycles propagate across countries and regions and their underlying factors is highly important to investors and policy makers. Furthermore, in the case of monetary unions, business cycle synchronisation is taken as an indication of a low probability of asymmetric shocks and so of a low cost of losing independence over monetary and exchange rate policies.

Fluctuations of economic activity at regional level are likely to be more important than at national level because regions trade relatively more than countries and specialisation at regional level is higher than at national level.

A recent published paper\*\*, analysed the patterns and determinants of the co-movement of economic activity between regions in the European Union and the Euro Area. Specifically, a panel data set of 208 regions over the period 1989-2002 was used to analyse the impact of regional trade integration, industry specialisation and exchange rate volatility on regional output growth synchronisation with the Euro Area.

The main research findings of the paper are as follows. Over the analysed period, average regional output growth correlations with the Euro Area have remained stable. They were slightly higher for the regions in the Euro Area countries. Trade integration and industrial specialisation relative to the Euro Area average has increased in the Euro Area regions. Exchange rate volatility has generally decreased in the European Union's regions but was higher in the regions outside the Euro Area in comparison to Euro

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Area's regions. Deeper trade integration with the Euro Area had a strong direct positive effect on the synchronisation of regional output with the Euro Area while industrial specialisation and exchange rate volatility were sources of cyclical divergence. Industrial specialisation had however an indirect positive effect on output growth synchronisation via its positive effect on trade integration, while exchange rate volatility had an indirect additional negative effect on output growth correlations by reducing trade integration.

On average, income differentials between regions and the Euro Area as well as regions' size were negatively related to industry specialisation. Higher income regions traded more intensively with the Euro Area. While the direct positive effect of trade on regional output synchronisation with the Euro Area was stronger in the period before the adoption of the euro, the negative effect of industry specialisation was stronger since the adoption of the single currency. Regions in the Euro Area experienced a direct positive and significant effect of exchange rate volatility on output growth correlations before the adoption of the single currency which suggests that the exchange rates acted as shock absorbers.

These research results suggest a number of relevant policy implications for the European Economic Monetary Union. First and foremost, promoting trade integration with the Euro Area is likely to foster regional output growth synchronisation and thus lower the probability of regions experiencing asymmetric shocks. Second, real income convergence with the Euro Area average is expected to increase trade integration and at the same time affect the pattern of industry specialisation towards more similarity which in turn will increase regional output growth with the Euro Area. Finally, given that asymmetric shocks are still likely, policy makers should focus on increasing labour and product market flexibility as mechanisms for adjustment to region-specific shocks.

\*\*SIEDSCHLAG, I. and G. TONDL, "[Regional Output Growth Synchronisation with the Euro Area](#)", *Empirica*, DOI 10.1007/s10663-010-9130-7, published online 27 March 2010.

# THE IMPACT OF SOCIAL PARTNERSHIP ON IRELAND'S COMPETITIVENESS

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Social partnership has been a central facet of Irish society since 1987. In order to support economic growth, a principal objective of the partnership process has been to achieve moderate increases in wages in exchange for reductions in income tax to boost take home pay. To achieve this outcome, one of the core elements of social partnership is a centralised wage agreement negotiated between the Irish Government, the main employer bodies and Trade Unions. These wage agreements, known as the National Wage Agreements (NWA), have been identified in a number of studies as having played a pivotal role in the remarkable revival that occurred in the Irish economy in the late 1980s, and the considerable growth that took place in the country over the 'Celtic Tiger' era. In particular, most of the research indicates that the wage restraint attained under the pay agreements enhanced the country's competitiveness, through lower labour costs, and this consequently led to both significant employment and economic growth. Real unit labour costs in Ireland have fallen in most years since the social partnership process began in 1987. Over the 1987-2002 period, unit labour costs fell by around 25 per cent in Ireland compared to, approximately, 10 per cent across the EU. Thus, this would seem to suggest that the wage increases under social partnership have been modest enough to boost Ireland's international competitiveness.

Nevertheless, most of the evidence presented is of a highly descriptive nature and, to date, the relationship between the NWA and competitiveness has never been explicitly tested. Our paper\*\* analyses data from 6,500 private sector firms, drawn from the CSO's 2003 National Employment Survey (NES), to analyse the impact of institutional wage bargaining arrangements on levels of average labour costs and within firm wage dispersion in private sector corporations in Ireland.

Over 5 out of 6 firms reported that the dominant mode of bargaining over wages in their firm was at either individual level, firm level, business-

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level or national wage agreement level. *Individual-level* contracts represent the situation where the worker negotiates directly with management. *Business-level* and *industry-level* agreements represent bargaining by trade-unions on behalf of all workers within the firm or industry respectively. The *national wage agreement* describes the pay determination that arises directly as a result of the social partnership process. Clearly, business, industry and national-level represent the various types of collective wage bargaining. Within the data, individual-level bargaining was found to be the dominant pay strategy within 43 per cent of firms in Ireland in 2003. The NWA was the next most common form of bargaining, adopted by 28 per cent of companies, while business-level and industry-level agreements were each implemented in 7 per cent of firms respectively<sup>1</sup>.

The analysis conducted revealed that relative to the NWA, average labour costs were higher in firms implementing individual and business-level bargaining. However, important differences emerged for indigenous firms and multinational companies (MNC's). In particular, the research indicated that MNCs implementing the NWA enjoy a labour cost advantage that exceeds that of other multinationals *and* indigenous firms holding other characteristics constant. This result suggests that there have been large gains, in terms of competitiveness, to MNCs that locate in Ireland. However, what are the mechanisms through which social partnership leads to a competitive advantage to MNCs? The most obvious possibility is that MNCs prefer to locate in countries with centralised bargaining, due to the gain in competitiveness associated with wage setting aimed at securing the interests of domestic firms. Specifically, within a social partnership system, trade unions will choose to limit wage demands in order to preserve employment levels in less competitive domestic firms. Consequently, MNCs adopting the NWA, which is designed to protect employment in indigenous companies with lower productivity levels, are able to set wages at levels well below what would normally be the case than if bargaining was undertaken by trade unions at the business-level or where individuals negotiated directly with their employer.

\*\* MCGUINNESS, S., E. KELLY and P.J. O'CONNELL (2010). "[The Impact of Wage Bargaining Regime on Firm-level Competitiveness and Wage Inequality: The Case of Ireland](#)", *Industrial Relations: A Journal of Economy and Society*, Vol. 49, No. 4, pp. 593-615.

<sup>1</sup> In approximately 15 per cent of firms no single type of agreement was dominant.

# COMMUTING BEHAVIOUR AND CAR OWNERSHIP IN IRELAND

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## Introduction

Rapid economic, demographic and social change in Ireland over the past fifteen years, with associated increases in car dependence and congestion, has focused policy on encouraging more sustainable forms of travel. Data for journeys to work, school and college confirm the shift towards the private car. The proportions driving to work increased from 46 per cent in 1996 to 57 per cent in 2006, while the proportion of primary school students travelling as car passengers increased from 36 per cent in 1996 to 55 per cent in 2006, overtaking the proportions walking (24 per cent), which had traditionally been the primary means of transport to school for this age-group. In this context, knowledge of current travel patterns and their determinants is crucial. In a series of recent papers, ESRI researchers use micro-data from a variety of sources to examine various aspects of commuting behaviour and car ownership in Ireland.

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## Commuting Behaviour

Analyses of travel behaviour by individuals typically focus on the journey to work, due to the availability of data and the potential for behavioural change resulting from the routine and repetitive nature of the journey. The first<sup>†</sup> of two papers on commuting behaviour analyses the demographic, socio-economic and supply-side determinants of the choice of mode of transport to work in the Greater Dublin Area. Using detailed micro-data on the full population of working individuals from the 2006 Census of Population, the results indicate that household composition (particularly the presence of young children), public transport availability, car availability, journey time and work location are particularly important in explaining variation in mode choice across the working population.

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While proximity to a QBC (quality bus corridor) is significant in explaining the increased probability of travelling to work by public transport, it is insignificant in explaining cycle use, which suggests that QBCs should not be considered a substitute for dedicated cycle lanes. A number of characteristics have divergent effects on bus and train use; while those with higher levels of education are significantly less likely to travel by bus to work, they are significantly more likely to travel by train. This suggests that the bus may suffer from an image problem and that continued investment in measures such as QBCs and express bus services for commuters may be needed to improve the attractiveness of the bus as a mode of transport to work.

In the second paper<sup>††</sup>, the authors extend the analysis to account for the possible endogeneity of the car ownership decision by analysing the joint decision of car ownership and mode of transport to work. Using the same micro-data from the 2006 Census of Population, they also extend the analysis to the entire country, and estimate separate models for Dublin city and county, the commuter counties of the Greater Dublin Area, other urban areas and rural areas. The analysis also incorporates information on travel costs for the first time.

As with the earlier analysis, household composition (particularly the presence of young children), public transport availability and journey time are found to be particularly important in explaining variation the car ownership-mode choice decision. The results for journey time and cost are highly significant, indicating that a change in the relative time or monetary costs of public transport relative to driving a car are likely to make these more sustainable modes more attractive to commuters. The results suggest that travel time exerts a stronger influence on individual travel behaviour. In this context, measures which seek to make more sustainable modes of transport more comparable with the private car in terms of journey times (e.g., dedicated cycle and bus lanes, more frequent public transport services, etc.) may be just as important as monetary incentives in inducing individuals to travel by more sustainable forms of transport.

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## Car Ownership

As the preferred mode for the majority of individuals' journey to work, it is worth examining the car ownership decision in greater detail. Using longitudinal data from the Living in Ireland Survey over the period 1995-2001, the third paper<sup>†††</sup> examines the determinants of household car ownership. This was a period of rapid economic and social change in Ireland, with the proportion of households with one or more cars growing from 75 per cent to 81 per cent over the period.

There is a high degree of persistence in household car ownership decisions, with previous levels of car ownership highly significant in explaining current ownership. The income effects suggest that permanent income (the so-called 'long-run' effect) exerts a stronger and more significant effect on household car ownership than current income (the 'short-run' effect). In addition, income elasticities are found to differ by previous car ownership status, with income elasticities much higher for those with no car in the initial period. Other household characteristics such as the presence of young children and the employment status, marital status and education level of the household reference person are also important influences on household car ownership.



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## Summary

While the data upon which these analyses were based refer to the period before the sharp downturn in the Irish economy, the results have a number of implications for policy. In terms of encouraging more sustainable modes of transport for the journey to work, policies which result in favourable journey times for walking, cycling and public transport could be particularly effective. The persistence of household car ownership over time, as well as the importance of household characteristics such as the presence of young children, creates challenges for policymakers in trying to change behaviour. Commuting and car ownership are just two of the many transport-related decisions that have important economic and environmental implications for Ireland; further research is ongoing at the ESRI on other aspects of transport behaviour such as mode choice for other journey purposes (e.g., travel to school), as well as the impact of recent tax changes on car ownership decisions.

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# PROVIDING QUALITY PHARMACY SERVICES: GOOD INTENTIONS ARE NOT ENOUGH

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Elected representatives, like consumers, want reliable good quality medical services. Pharmacy services are no exception. Providing sound advice on which drug to take for a minor ailment, or the common side effects of a drug or keeping careful track of a consumer's drug regimen, promote good health outcomes.

Government in 1996 introduced two inter-related policies designed to raise the quality of pharmacy services in Ireland.

- First, the Health (Community Pharmacy Contract Agreement) Regulations, 1996. The 1996 Pharmacy Regulations confined the opening of new pharmacies to instances where there was a 'definite public health need.' Minimum distances were specified between pharmacies. New pharmacies could not threaten the viability of an existing pharmacy.<sup>1</sup>
- Second, the 1996 Community Pharmacy Contract, between an individual pharmacy and a Health Board, specified that pharmacists were to provide certain services drawing on their professional knowledge and expertise. These included checking the drug regimen of a consumer, including the examination of the rational and cost effective use of medicines.

Government funded community drug schemes account for the vast majority of drugs dispensed.

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<sup>1</sup> These regulations were unexpectedly revoked in January 2002 following legal action.

These two policies appear, however, to have had little effect on the quality of pharmacy services, while having some undesirable side effects:

- The 1996 Pharmacy Regulations led to a drastic decline in the opening of new pharmacies, despite a large increase in demand, with the result that the value of pharmacies was inflated considerably – by between 40 per cent and 60 per cent. There is little evidence that these restrictions on entry led to any improvement in service quality – casting doubt on the purported rationale for the policy. If pharmacists, as private parties, has agreed collectively to these regulations they would almost certainly have been guilty of a breach of Section 4(1) of the Competition Act, which prohibits anti-competitive agreements.
- The 1996 Community Pharmacy Contract provisions relating to improved pharmacy services for consumers are aspirational. The provisions are largely unenforceable; do not recognise the conflicting motivations of a pharmacist and result in no measurable output.

Five lessons are presented so as to inform future community pharmacy contracts so as to better realise any desired improvements in service quality.

***Lesson #1: Avoid Regulatory Capture*** – Government intervention should promote consumer welfare and be consistent with the better regulation agenda, rather than, as appears to be the case here, primarily benefiting the producer – incumbent pharmacies.

***Lesson #2: A Valid Rationale?*** – Regulatory intervention requires a valid rationale such as market power, externalities or information asymmetries that is consistent with the facts. The rationale for restricting the opening new pharmacies was “over competition.” The evidence suggested no such state of affairs; if anything the pharmacy market had many of the hall marks of a protected less than competitive market that required more competition and more not less entry.

***Lesson #3: Contracts Should be S.M.A.R.T.*** – A contract between a purchaser, such as the health board, and provider, such as a pharmacy, should be well specified. They should be SMART – Specific; Measurable; Attainable; Realistic; and Timely – rather than aspirational.

***Lesson #4: Incentives Count, So Don't Ignore Them*** – Regulatory regimes or contracts for services should ensure that these are incentive compatible with the motivation of the provider. If pharmacists are compensated on the basis of a mark-up on the cost of a drug then they will have an incentive to dispense a high priced brand. Expecting the pharmacist to spend time persuading the physician to prescribe a lower priced brand, since the pharmacist is not able to dispense a lower priced brand without permission, is thus doubly unlikely – a loss in income from dispensing a lower priced brand and the time taken to persuade the prescriber.

***Lesson #5: Markets Do Work: Working with Rather than Against the Market*** – New entrants typically supply new ideas, new ways of doing things, with the result that productivity and innovation increase.

Competitive markets are able to provide improved services in terms of prices and other non-price aspects that are valued by consumers, such as opening hours, home delivery and so on.

It could, of course, be argued that these lessons are of historical interest only. In fact, they are still highly relevant, as evidenced by the statement as of 2009 from the Pharmaceutical Society of Ireland, the pharmacists' regulatory body: "[A] model based on the 'free market' should be discouraged and instead the normative need of the patients and population should be the driving forces behind a new generation of pharmacy services. Restrictions on new pharmacy openings should be considered and a methodology that optimises fair access for patients and ensures pharmacies are located where need is identified, should be developed."

GOECKI, P. K., 2010. "[Do you believe in magic? Improving the quality of pharmacy services through restricting entry and aspirational contracts, the Irish experience](#)", *European Journal of Health Economics*, published online 9 July 2010.





Published by  
The Economic  
and Social  
Research Institute  
Whitaker Square  
Sir John Rogerson's  
Quay  
Dublin 2